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Guide to Investment Planning

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NOTICE TO READERS

The Guide to Investment Planning, prepared by the Personal Financial Planning (PFP) Investment Planning Task Force, has been published as the Investment Planning module of the looseleaf AICPA Personal Financial Planning Manual, as it appears in the May 1990 update.

The nonauthoritative practice aids in this guide do not present positions but attempt to offer some alternatives that practitioners can choose from and then modify, if necessary, to meet their needs. They are intended as time-saving illustrations and tools. They are not intended to establish standards or preferred practices. Authoritative technical literature should be consulted in carrying out all engagements, including personal financial planning engagements.

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PREFACE

The Personal Financial Planning Division has prepared this manual of nonauthoritative practice aids to assist certified public accountants in the efficient and competent delivery of personal financial planning services to their clients.

This practice aid is intended for practitioners who are developing comprehensive personal financial plans as well as those performing segmented planning and consultation engagements. This guide contains previously released material which was distributed as part of the May 1990 update to the PFP Manual.

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INTRODUCTION

A primary purpose of personal financial planning is to use financial resources more effectively to achieve financial goals. Investment planning is therefore a necessary part of comprehensive personal financial planning. In addition, it is often an important consideration in consultations and in income tax, insurance, retirement, estate planning, and education funding.

The AICPA's Code of Professional Conduct, which governs CPAs who perform investment planning and other professional accounting services, requires CPAs to perform their services with integrity and objectivity while avoiding conflicts of interest.

This module addresses practice management considerations and procedures for providing investment planning services. The procedures rely on the traditional skills and analytical abilities of CPAs.

The practice management topics describe the areas of investment planning that are uniquely suited to the expertise and background of most CPAs. Firms can first decide on the level of investment planning and then plan the implementation services they will provide. Several possible levels are described. Registration as an investment adviser is discussed. Whether registration is required will, in large measure, depend on the level of investment planning and implementation services provided.

Following this discussion is an explanation of the thirteen procedures in the investment planning process. After the procedures are listed, each procedure is discussed separately. Some procedures include expanded material for certain aspects of the procedure that are particularly important for successful investment planning. Following the discussion of the procedures, they are illustrated by a goals-funding model. The model explains the steps required for a CPA to be able to quantify a client's financial goals (such as education funding), consider the client's investment constraints, and arrive at a funding recommendation. A goals-funding approach may not be appropriate if the client's financial goals are the accumulation of general wealth or the reduction of risk. In those situations, CPAs develop investment strategies to satisfy those goals, using approaches that are similar to, but less structured than, the goals-funding approach.

Following the goals-funding model, a separate section addresses investment planning considerations in segmented engagements. This section describes investment planning issues that may arise when segmented engagements in other PFP areas are performed. Consultations on investment planning areas are also addressed. A section also considers the CPA acting as a purchaser representative.

The final section contains a description of investment products, including certain characteristics that affect their suitability as investment and funding vehicles.

Many of the investment strategies contained in this module deal with securities transactions. The module does not deal with how investment objectives can be dealt with by other types of investment vehicles.

PRACTICE MANAGEMENT TOPICS

THE INVESTMENT PLANNING PROCESS

In the investment planning process, CPAs help clients determine effective investment strategies for achieving their financial planning goals. In most engagements, some of the steps described in the investment planning process will have already been carried out as part of the overall personal financial planning process. They are mentioned again here to describe how they relate to investment planning.

The investment planning process includes--

1. Establishing a comprehensive data base that includes the client's goals and objectives.

2. Analyzing the client's financial situation.

3. Providing investment planning advice. This advice may be limited to educational assistance regarding investment strategies, guidance regarding asset allocation recommendations, or specific investment recommendations.

4. Assisting with implementation.

5. Providing ongoing assistance.

THE ROLE OF CPAs IN PROVIDING INVESTMENT PLANNING SERVICES

In financial matters, CPAs have acquired analytical skills and experience that make them especially qualified to serve as objective advisers. In several areas, CPAs are in a position to assist their clients more effectively than most other advisers. They are often able to provide an objective review of the investment recommendations of other advisers and counsel their clients regarding the risk, liquidity, tax and management characteristics of the investments.

During the investment planning process, CPAs often improve their clients' decision-making abilities by educating them about financial and investment strategies. They advise clients on the use of credit, investment decisions related to corporate benefit plans, appropriate amounts of risk to assume and strategies such as dollar-cost averaging.

CPAs provide objective help to their clients so that they undertake only as much investment risk as is necessary to satisfy stated financial goals. CPAs do this by illustrating the risk and financial impact of alternative investment strategies.

DECIDING THE LEVEL OF INVESTMENT PLANNING SERVICES

Before offering personal financial planning services to clients, CPAs determine the level of investment planning services that they will provide. CPAs may choose to provide general guidance regarding investment strategies, provide specific guidance regarding investment asset allocation strategies, or recommend specific investments.

CPAs also determine what level of investment planning implementation assistance to provide. Possible implementation services may include--

- Educating clients and providing general guidance regarding methods of implementing investment decisions.
- Developing a timetable for the client and monitoring the client's progress.
- Assisting the client's investment advisers and brokers.
- Providing the client with a list of investment managers, brokers, or both.
- Helping the client interview investment managers, brokers, or both.
- Recommending investment managers, brokers, or both for the client's consideration.
- Providing the client with mutual fund ratings and helping the client analyze mutual fund prospectuses.
- Reviewing the suggestions of the client's advisers and brokers.
- Recommending specific mutual funds for the client's consideration.
- Recommending specific stocks and bonds for the client's consideration.

At times, CPAs may also provide investment monitoring services to clients. If they choose to do so, they determine the frequency of the monitoring services and what comparative benchmarks to use.

REGISTRATION AS AN INVESTMENT ADVISER

CPAs who provide personal financial planning services will want to become familiar with federal and state registration requirements for investment advisers. The Personal Financial Planning Division's practice aid Issues Involving Registration Under the Investment Adviser's Act of 1940 provides information about federal requirements. Whether federal or state registration is required depends on the facts and circumstances of each practice. It is a matter that should be discussed with legal counsel.

PROFESSIONAL LIABILITY COVERAGE

Professional liability coverage is a consideration when deciding the level of investment planning and implementation services to provide. As discussed on page 1-44.2, some

policies may exclude coverage for professional services that include recommendations of specific securities. Some may exclude coverage of investment advisory services if the CPA is registered as an investment adviser.

CPAs who provide investment planning services to clients should review their liability coverage to determine if it covers those services. Depending on the policy and the services offered, a separate policy covering certain investment planning services may be needed.

PROCEDURES TO IMPLEMENT THE INVESTMENT PLANNING PROCESS

The overall goal of investing is the creation or conservation of financial resources, or a combination of both goals. (For matters regarding distribution of an estate, see the module titled "Estate Planning Module.") Clients may not have a clear understanding of the purposes of investing and may have a habit of purchasing investments without a plan.

CPAs can help reduce their clients' confusion and concern about investment decisions. They can educate their clients to understand that the process of identifying personal financial objectives and selecting investment strategies are steps that should precede investment decision making.

The ability to create the financial resources that are necessary to meet financial goals requires the accumulation or saving of assets to (1) pay for one or more specific financial objectives in the future, (2) create an estate, or (3) maintain a desired lifestyle. The rate of accumulation depends on the availability of cash flow and the client's ability to plan and manage cash flow.

The selection of investment strategies to create financial resources requires CPAs to gather sufficient information to help clients focus and make decisions. The procedures required in investment planning depend on the nature and complexity of a client's financial situation and the nature and magnitude of a client's financial goals.

A comprehensive analysis usually requires the following investment planning procedures:

1. Determine the client's financial objectives and their order of importance.
2. Analyze the client's financial position and cash flow. Suggest changes in the client's position and analyze priorities, if necessary.
3. Determine the client's priorities for the allocation of financial resources among stated non investment objectives, such as the amount of emergency funds and the acquisition of additional insurance. Calculate the remaining assets that will be available to meet investment goals.
4. Gather information regarding investment opportunities offered by the client's employer.
5. Gather and analyze the data necessary for developing the client's investment profile, including indications about the client's general disposition toward risk.

6. Determine the risk and return characteristics of the client's current investments.
7. Select financial assumptions.
8. Determine the adequacy of the client's resources for achieving stated investment goals and analyze the appropriateness of the client's current investment strategies. If resources are insufficient, consider revising the allocation of resources, changing goals, or using investments with higher risks and yields. (See the discussion of goals funding on page 3-6.72)
9. Provide the agreed on level of investment planning service.
10. Provide the agreed on level of implementation service.
11. Provide any agreed on investment monitoring services.
12. Provide any agreed on ongoing services and update the plan as necessary.
13. Document the investment planning procedures, the client's decisions, and the CPA's continuing responsibilities.

Each of these procedures is described below.

STEP 1--DETERMINING FINANCIAL OBJECTIVES

The first step in the investment planning process is to determine both the client's financial objectives and their order of importance. The CPA begins this process by discussing the client's concerns with the client. The client may be able to list the financial objectives, and additional ones may be brought up as the CPA and client discuss the personal financial planning process.

In an effort to be thorough, or to assist clients who may not have clear financial objectives in mind, CPAs could have clients complete one or more work sheets that list goals or questions relating to common goals. (The module titled "General Information" contains several such work sheets. Exhibit 3-1B illustrates a client goals worksheet, which lists more than twenty financial goals and objectives and asks the client to indicate the importance of each. Exhibit 3–1C illustrates an assumptions and objectives worksheet, which comprises a series of statements about common goals that the client responds to by indicating their importance. It also includes questions about other relevant issues, such as health, insurance, and risk tolerance. On the objectives worksheet, Exhibit 3-1D, the client quantifies certain objectives, such as retirement income, disability income needs, and education funding.)

When discussing financial objectives, the CPA will find it helpful to have at least some summary financial information about the client, as well as some general information about insurance coverage and the client's tax situation and estate plan. A simple form, such as Exhibit 1-2, which contains a personal financial profile form, may be used to get an overview of the client's financial situation.

Once his or her significant financial objectives have been identified, the client needs to determine their order of importance. Each goal also needs to be quantified. For example, through discussion, or perhaps a little research, the client's goal of a down payment on a vacation home can be restated as a $35,000 down payment in three years.

STEP 2--ANALYZING THE CLIENT'S FINANCIAL POSITION

The CPA's analysis of the client's financial position and cash flow provides necessary information for the investment planning process. Discussions with the client or a review of the client's statement of financial condition will indicate to the CPA whether the client is successful in accumulating assets or if there is a problem of excessive debt. The client and CPA can determine whether the amount of liquid assets appears adequate. The statement will provide the client's current asset allocation, which may indicate the client's investment preference. It may also provide information for an analysis of the diversification and yield of the present portfolio.

Data-gathering forms, workpapers for developing clients' statements of financial condition, and a discussion of financial statement analysis are included in the technical module titled "Financial Statement Analysis" (page 3-2.01).

A cash flow statement provides the CPA with needed information about the amount of discretionary cash flow available to the client to meet financial goals. It is often prepared using the client's estimate of current income and expenses.

If the client does not have the information available to determine the amount of available discretionary income, it may be necessary to accumulate information about actual income and expenses. In some cases, a budgeting plan may be needed to help the client accumulate funds for financing financial goals. (See the module titled "Cash Flow Planning" for gathering information about the client's cash flow.)

Identifying Investment Assets

An important part of the investment planning process is the identification and valuation of assets that are available to satisfy or fund financial goals. Current values of certain personal assets may be partially or fully included as investment assets if they will be liquidated at some future date to meet a financial goal. Primary and secondary homes, art, antiques, jewelry, and collectibles are examples of such assets. If a client plans to retain a personal asset indefinitely, it is not an investment asset.

Whether equity in the family business is available to meet financial goals also requires careful evaluation. Investment strategies will differ depending on whether such assets will be used to fund goals. If indefinite retention of the family business is desired, the business is not considered an asset available for liquidation and repositioning. However, the investment characteristics of the business (such as its value and the stability of its cash flow) may affect asset allocation decisions.

Importance of Forms of Ownership

Investment planning includes reviewing the form of ownership of investment assets. There may be income tax implications to consider. If the assets are held in a qualified retirement

account, the absence of income taxes on the account will affect the overall investment strategy, including the type of investment chosen. Similarly, the information about who will be taxed on deferred types of trust income may affect the planning for assets held in a personal trust.

The form of ownership may also affect the disposition of the property. Investments held for retirement funding, for example, may not be available to meet certain financial objectives. It may be inappropriate to use such funds for college tuition payments. A review of a trust's pay out provisions will help the CPA determine if it fits the client's requirements.

Ownership also has estate planning implications. It may be advantageous to put the growth portion of a client's portfolio in a trust that will be exempt from estate tax at the client's death or that qualifies for the marital deduction, if applicable. The reverse is also true. If the asset will be taxed in the client's estate, perhaps this should be considered in determining an investment strategy. (For additional information, see the discussion of property ownership considerations in the module titled "Estate Planning.")

STEP 3--ALLOCATING RESOURCES TO NONINVESTMENT OBJECTIVES

Before advising clients to allocate savings toward goals-funding objectives, CPAs determine whether their clients have sufficient liquidity available for emergencies and adequate insurance coverage. If their emergency fund is inadequate and other resources (such as insurance and personal lines of credit) are not available to meet emergency needs, clients should accumulate savings to build this fund.

Clients also need adequate insurance coverage. Before undertaking the discretionary goals-funding process, clients should have adequate amounts of life and disability insurance, health insurance, and property and liability insurance.

Clients may have additional non investment objectives that have a high priority. The cost of achieving the non investment objectives is deducted from the clients' available cash flow to determine the cash flow available for goals-funding and investment.

STEP 4--IDENTIFYING INVESTMENT OPPORTUNITIES OFFERED BY EMPLOYER

Clients' employers may offer a variety of investment opportunities, such as 401(k) plans, 403(b) plans, SEPs, ESOPs, stock option plans, stock appreciation rights, and deferred compensation arrangements. Clients must provide their CPAs with information about such opportunities because it may affect their investment planning recommendations. Some of the programs may be desirable investment opportunities and may also provide tax advantages. Certain programs may be useful for funding goals, especially retirement funding.

An additional consideration is that plans may offer clients a choice of investment vehicles. Clients should make such decisions in the context of their financial objectives and overall asset allocation.

STEP 5--IDENTIFYING THE CLIENT'S INVESTMENT PROFILE

After goals are established and financial resources are identified, the CPA gathers and analyzes data to understand the client's investment profile. Through discussions with the client and analysis of data-gathering forms and questionnaires, the CPA tries to identify constraints on the client's overall situation and financial goals. The investment constraints affect the amount of risk the client can assume and the suitability of various investment vehicles.

The following are constraints that may affect the selection of suitable asset categories in carrying out a client's financial plans:

- Risk tolerance
- Time horizon
- Need for liquidity
- Tax considerations
- Need for diversification
- Need or ability to handle certain size investments
- Present or future need to use the asset as collateral
- Required management time

A constraint is defined as a restriction. This section describes parameters of investor constraints so that the final portfolio strategy fits the client. [1]

Risk Tolerance

Clients' tolerance for investment risk is an intangible and subjective constraint that depends on numerous factors, including their emotional temperament, attitude and investment experience. The level of risk clients are willing to assume affects the investment categories that can be considered for funding financial planning goals. Some clients prefer investments that have little fluctuation in total return, such as money market instruments and short-term fixed-income securities. Some clients are loss-averse and prefer investments that have a low single-period probability of loss. Risk tolerance may vary depending on the goal. It may be much lower for a goal to fund a client's children's education than for funding a vacation.

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[1] The preceding materials on clients' investment profiles are adapted from, Analysis and Role of Investments in Personal Financial Planning, Donald J. Sedam, AICPA, 1989. Reprinted by permission.

Two aspects of risk tolerance need to be considered: the client's desire to assume investment risk and their ability or capacity to assume the risk. By evaluating a client's risk tolerance, CPAs determine whether the investments owned, or being considered by their clients, comply with their desire and capacity for taking investment risk. A desire to take risk should not exceed a capacity to take risk.

When desire exceeds capacity, investing becomes gambling, possibly including the use of encumbered resources or resources belonging to others. An intent by a client to take more risk than risk capacity will allow him or her may indicate either a significant ignorance of investments or possibly a character flaw.

What Determines Desire for Risk. The identification of the level of a client's desire for investment risk is difficult. It is generally believed that individuals usually express a greater willingness to assume investment risk than they actually have. This misrepresentation may result from a misguided desire for acceptance or the need to be considered more financially daring than they actually are.

Techniques for a CPA to learn about a client's desire to assume risk include discussions with the client about risk and the client's investment preferences, diagnostic questionnaires, and a review of the client's investment history. There are two types of diagnostic questionnaires: psychological questionnaires and investment preference questionnaires. Questionnaires can be especially helpful when a client wants to assume a risk that the CPA considers excessive. Such a test can help clients evaluate their risk tolerance.

Following are questions extracted from William Kuehl's "Financial Risk Yardstick", a psychological questionnaire that quantifies the relationship between the client's desire and capacity to assume risk.

- Would you take a job on a strictly commission basis?
- Are you highly energetic?
- Would you invest in speculative stock?
- Do you play poker, the lottery or other games of chance for money?

Some CPAs evaluate their clients' desire for risk by discussing with them various investment vehicles and investment risks. William G. Droms has developed an asset allocation method based on such questions. The following statements are excerpted from his "Portfolio Allocation Scoring System, Version 3", in which clients must rank the following in order of importance:

	STRONGLY AGREE	AGREE	NEUTRAL	STRONGLY DISAGREE	DISAGREE
• Earning a high long-term total return that will allow my capital to grow faster than the inflation rate is one of my most important investment objectives.	5	4	3	2	1
• I would like an investment that provides me with an opportunity to defer taxation of capital gains and\or interest to future years.	5	4	3	2	1
• I do not require a high level of current income from my investments.	5	4	3	2	1
• My major investment goals are relatively long-term.	5	4	3	2	1
• I am willing to tolerate sharp up and down swings in the return on my investments in order seek a potentially higher return than would normally be expected from more stable investments.	5	4	3	2	1
• I am willing to risk a short-term loss in return for a potentially higher long-run rate of return.	5	4	3	2	1
• I am financially able to accept a low level of liquidity in my investment portfolio.	5	4	3	2	1

PORTFOLIO ALLOCATION MODELS

TOTAL SCORE	MONEY MARKET	FIXED INCOME	EQUITIES
30 - 35	10	10	80
22 - 29	20	20	60
14 - 21	30	30	40
7 - 13	40	40	20

The investment preferences questionnaire (exhibit 3-1E) and the investment alternatives questionnaire (exhibit 3-6K) are tools for evaluating clients' desire for risk by evaluating their responses to questions about investment characteristics and investment alternatives.

The investment pyramid (exhibit 3-6A) can illustrate to a client the general concept of investment risk without getting too technical. Different people might arrange some of the investments in a different order. Fixed-income investments, however, generally form the base and futures contracts and small speculative stocks are at the top of an increasing risk pyramid.

Determining a client's comfort zone is another way of evaluating their desire for risk. Some clients are comfortable only with investments below a certain risk on the pyramid. Others are comfortable with all the investment vehicles, if only a small percentage of their portfolio is invested in the vehicles near the top. The triangular shape implies that investors should have smaller holdings of the riskier investments.

Investor protection and risk tolerance are closely related. Some investors are comfortable only with FDIC or FSLIC savings accounts because they seek the protection of the $100,000 insurance provided by agencies of the federal government.

Other investors prefer bonds to stocks, because, as bondholders, they have a senior legal position for a claim against assets in bankruptcy. Bonds collateralized with specific assets have added protection.

Brokers and dealers who belong to the National Association of Security Dealers (NASD) carry Securities Investor Protection Corporation (SIPC) coverage. SIPC insures each account for up to $500,000 in total losses, including a maximum $100,000 cash loss, if a broker or dealer fails and a client's securities are lost or misappropriated. Many firms also carry private insurance that insures accounts up to $3 million. This coverage does not insure against market losses, however.

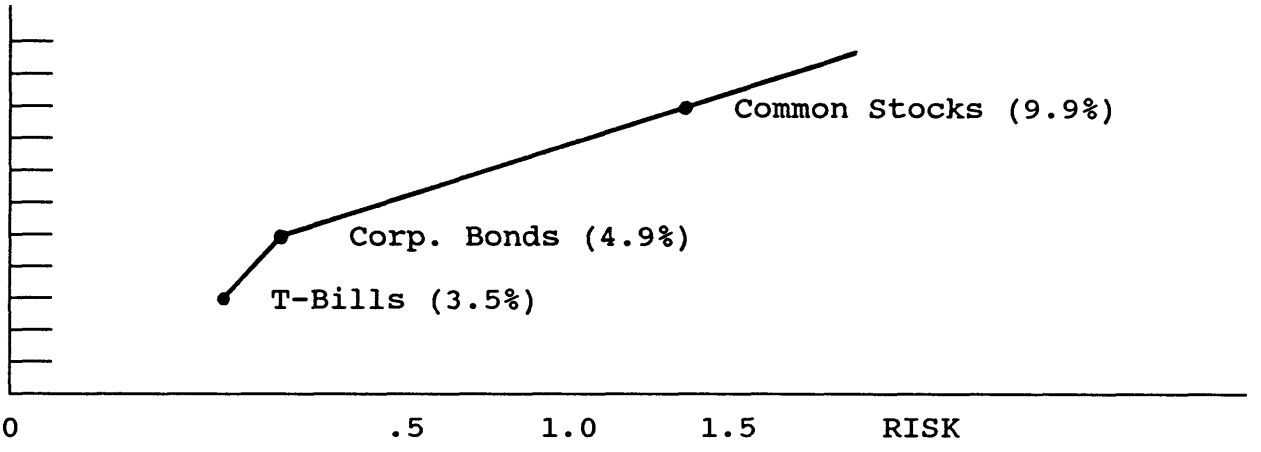
The marketplace requires that high-risk investments have the potential for more profit or return than low-risk investments. Rental property for instance may be subject to wide fluctuations in income because of the area's seasonal business patterns. A buyer would want to purchase the real estate at a price that is low enough to ensure a high rate of return because of such conditions.

The graph to the right is another simple way for CPAs to demonstrate the risk and reward relationship to clients without an involved discussion of investment risk. The vertical axis represents annualized returns. The horizontal axis indicates risk as measured by volatility (that is, the propensity of a security to rise or fall sharply in price within a short period of time). Stocks are assigned 1.0 on the risk axis. It is a midpoint for comparison with other investments. Actual returns may differ dramatically from the graph, depending on the time period selected.

GRAPH OF RISK AND REWARD

Based on Average Before Pre-Returns 1926-1988

ANNUALIZED RETURNS

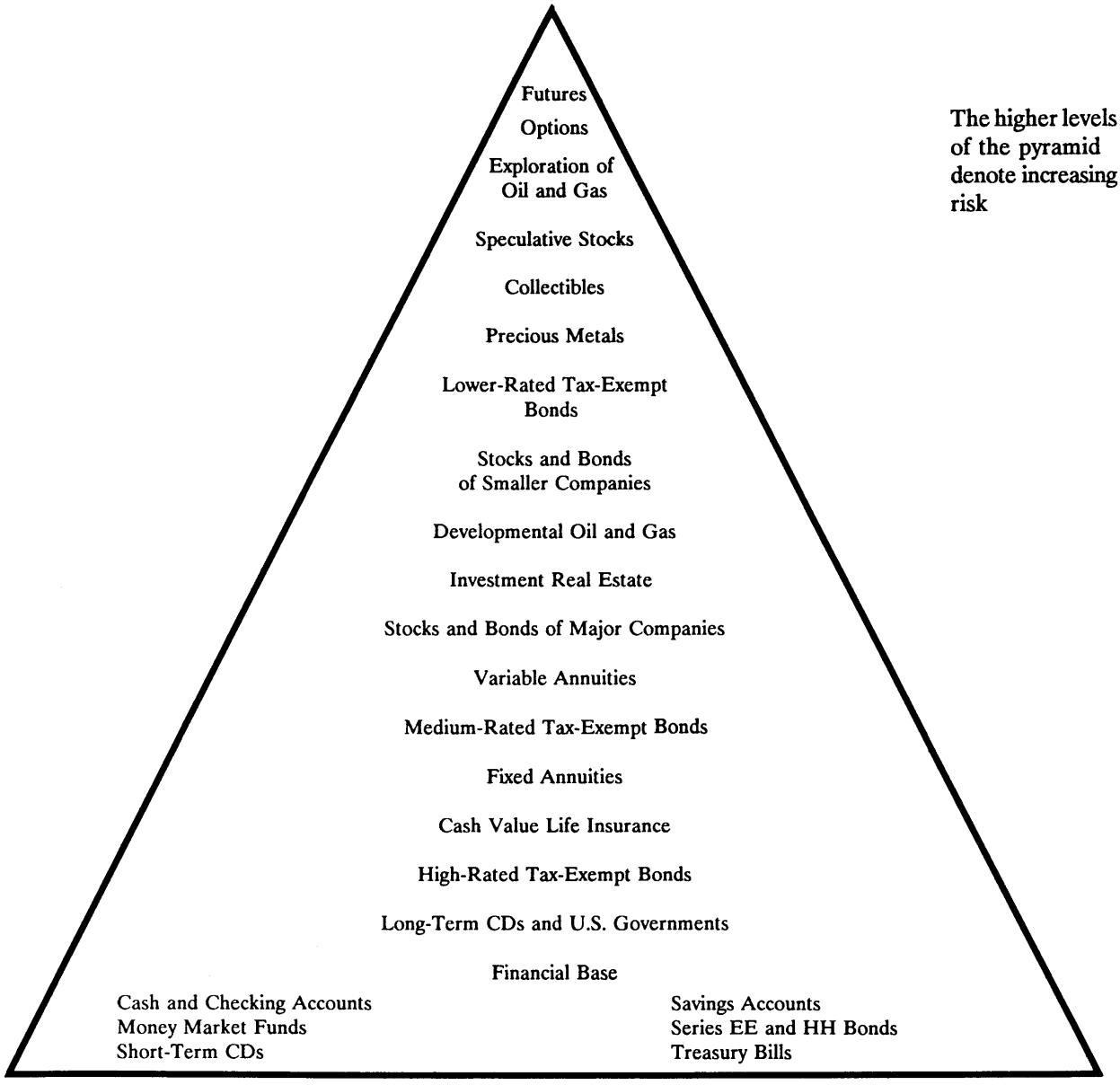


Source: Roger G. Ibbotson and Rex A. Sinquefield, Stocks, Bonds, Bills and Inflation: 1988. Reprinted with permission. (Ibbotson Associates, 1988), p. 28,33,43.

The graph above also illustrates the rate of return required to achieve clients' financial goals in the context of risk and return alternatives. Clients' required after-tax returns are converted to before-tax returns to correspond with the graph and the published return information. To calculate the before-tax return, divide the after-tax return by the following: *1-average tax rate*. This assumes that ordinary income and capital gains are taxed at the same rate, as is presently the case.

Exhibit 3-6A

INVESTMENT PYRAMID



The higher levels of the pyramid denote increasing risk

NOTE: The characteristics of specific assets and how they are used can dramatically affect where specific assets should be located on the pyramid.

Clients' before-tax returns are located on the vertical return axis, and a horizontal line is drawn across the graph. This horizontal line intersects the upward diagonal line at the required risk level that clients will have to assume to achieve their financial goals. Though not a precise device, it may be a useful, simple tool for illustrating the amount of risk clients need to assume, based on their stated financial goals and available resources.[2]

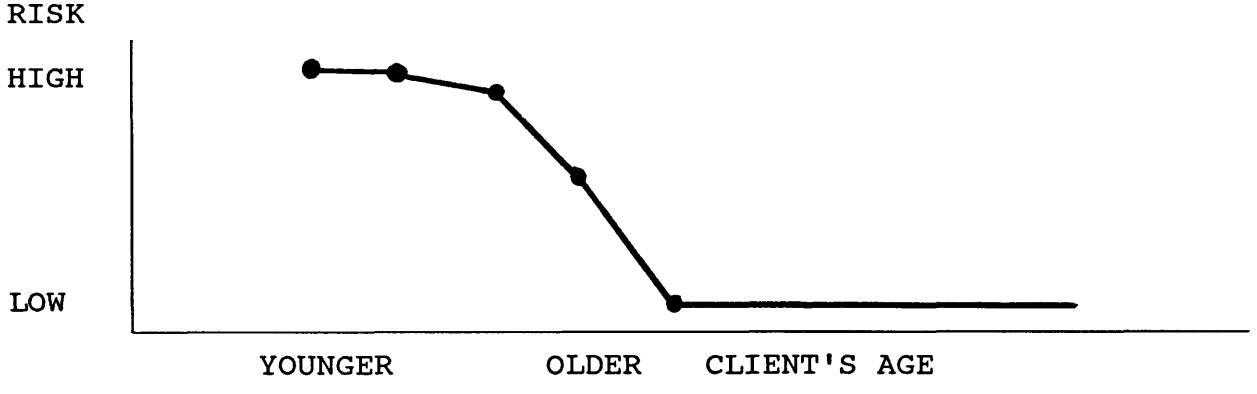
What Determines Financial Capacity. It may be assumed that every potential investor has a hypothetical limit for financial risk. This limit is a point that signals the maximum financial risk that the underlying resources and conditions will allow. The ceiling of capacity is not psychologically based but relies on physical conditions and financial facts.

Constraints on the Capacity to Assume Financial Risk

Although there are undoubtedly others, over twenty constraints in the capacity to assume financial risk are identified below. Many constraints interact; consequently, additional constraints are created for spouses with wide differences in age, health, and investment knowledge. The following are constraints on the capacity to assume financial risk:

Age. Often, as a person ages, he or she is less able to undertake financial risk. As clients approach retirement, less time remains to rebuild lost assets. Thus it is prudent to position financial investments into less risky products. The following graph generalizes this relationship.

GENERALIZED EFFECT OF AGING ON CAPACITY FOR RISK [3]



Guidelines on how aging generally affects client's investment decisions are discussed on page 3-1.02.

[2] The preceding material on the investment pyramid, investor protection, risk tolerance and the graph of risk and reward are adopted from Analysis and Role of Investments in Personal Financial Planning, Donald J. Sedam, AICPA, 1989, P. 6-8 to 6-11.

[3] Ibid. P.6-12. Reprinted with permission.

Several constraints mitigate the effect of aging on the capacity to assume risk. They include high levels of net worth, high annual income, and a younger spouse who has a good understanding of investments.

Marital Status. In general, single individuals have more of a capacity for financial risk than do married couples. There are, however, some factors that offset this increased risk capacity, such as health, age, number of dependents, level of income, and net worth.

Number of Dependents. The greater the number of dependents a client has, the less financial risk he or she can afford to assume. Some clients may have dependents who are not claimed on their tax returns but who receive significant aid from time to time. A client's goal may be to continue providing this support as needed. Some grown children face complex problems and need financial aid. Especially in large families, there is the likelihood of a child facing a severe financial problem. In addition, recent statistics show that more retired parents are becoming dependent on their children for financial assistance. This phenomenon is likely to increase as people live longer. A period of high inflation could also contribute to increased pressure on children to assist their retired parents.

Health. A person in poor health may need more liquidity and a more predictable cash flow. The uncertainty of poor health may require a more conservative investment approach. Consider the health of both spouses. If either has poor health, the couple's capacity for financial risk may be diminished.

Knowledge and Control of Investments. A good understanding of investments and investment strategies increases a client's capacity for investment risk. A limited knowledge reduces capacity. All investment products, including savings certificates, have significant attributes that determine their suitability. A client's understanding of those attributes is important in determining capacity for investment risk. A knowledgeable client retains control of the decision-making function.

Corporate executives frequently have control over corporate decisions as well as knowledge about their corporations, which reduces the risk they assume when investing in corporate stock. Similarly, a doctor may do research on a new drug and, based on the research, invest in the pharmaceutical company. The research has expanded the doctor's capacity to assume the risk of that investment.

A client with limited investment expertise can expand available investment alternatives by seeking a managed investment situation, such as mutual funds or an investment advisory account. A client's limited investment knowledge sometimes results in a heavy reliance on a product salesperson, who may have a conflict of interest.

Anticipated Inheritance. A client who will receive a significant inheritance within the foreseeable future may have a greater capacity for investment risk. The CPA's concern is whether the anticipation is justified. A guaranteed inheritance may be a funded irrevocable trust established for the benefit of the CPA's client. Anything less is subject to change and to the risk of consumption by the owner or the lifetime beneficiary.

Level of Income. In general, the higher the income, the greater a person's capacity for investment risk. This may not be true, however, if the client has little discretionary income or if the source of the income is unstable. For example, the client's salary history may widely fluctuate. A poor asset accumulation record or the existence of significant consumer debt may be evidence of cash flow problems. In addition, a greater capacity may be offset by a person's age, poor health, limited knowledge of investments, or other factors.

Although a pension is generally smaller than a salary, it is also more secure. A relatively high pension may indicate a higher capacity for financial risk when viewed along with other investment income and expenses.

Need for Investment Income. The greater the reliance a client has on investment income for living expenses, the less the capacity he or she will have for financial risk. The need for investment income may eliminate some potential investment classes from consideration.

Level of Debt. The existence of debt indicates that assets are leveraged; the greater the leverage, the greater the risk. Underlying assets that support the debt are subject to downward, as well as upward, changes in value. A mortgage on a primary residence is significantly less risky than a security margin account. A client's capacity for investment risk may be less because of the existence of debt.

Level of Investment Assets. A client's capacity for investment risk increases proportionately with the size of the pool of investment assets he or she owns. For example, a large pool of investments increases the possibility of reducing risk through diversification between and within asset categories. Very large investment portfolios may offset the downward effects that age, the number of dependents, knowledge of investments, etc., have on financial capacity.

Level of Net Worth. Net worth reflects the ownership of both personal and investment assets and may affect a client's capacity for investment risk positively or negatively -- reducing it if the net worth is low or increasing it if the net worth is high. Capacity may be further affected by the client's marital status. A single client may require less income for financial security; consequently, a high net worth might increase the capacity of a single client to assume investment risk more than it would that of a married couple.

Insurance Coverage. The client's failure to maintain adequate insurance coverage may significantly reduce his or her capacity for investment risk. The presence of the insurance coverage, however, may not necessarily increase the client's ability for investment risk, because the product is designed to protect against risk of loss as a result of death, illness,

property loss, or casualty. Inadequate medical and hospitalization insurance, life insurance, liability insurance, property insurance, and disability insurance indicate reduced capacity for investment risk.

Failure to carry hospitalization and medical insurance would negate most clients' capacity for investment risk. Self-insurance might indicate that all of a client's assets should be liquid in order to meet potential medical expenses. Holding illiquid investments could result in significant loss in the event of an unanticipated liquidation.

Two-Income Families. A two-career household adds substantial security to meeting life-style needs, savings ability, and retirement funding. The capacity for investment risk is increased if the total family income is split between two careers, assuming it is unlikely that either of the careers will be discontinued.

Opportunities in Present Employment. An excellent future in an employment position increases a client's capacity for investment risk. If a job offers limited opportunity or is insecure, the capacity for investment risk is reduced. The corporate takeover environment has made many managerial positions less secure. This situation may be partially offset by a spouse's secure career.

A secure position (for example, a civil service career) may provide an increased ability for investment risk even if future prospects for advancement are not certain. The predictability of income that comes with secure employment makes planning more reliable.

Closely Held Businesses and Sole Proprietorships. A self-employed client may have an increased capacity for investment risk if the business is mature and performing well. A mature business is one that has survived many economic cycles and appears to have a stable market for its product or service. If the business has performed well in the past and is expected to continue to do so, it probably provides many benefits to the owners that increase their capacity for investment risk.

Stability of Marriage. An unstable marriage has risk elements similar to those noted previously for clients who do not carry hospitalization and medical insurance. A divorce can result in financial catastrophe. If a marriage is known to be unstable, the capacity for investment risk is sharply reduced. This condition is not always easily diagnosed; however, symptoms of such a condition, if known, might include extramarital affairs, occupations with incompatible working hours or locations, and significant philosophical and social differences.

Time Horizon

An investor's time horizon is the amount of time available to attain a financial goal. The time horizon affects the investment vehicles used to attain the goal.

If a client has a high-priority goal with an extremely short time horizon, a low-risk money market instrument (such as a Treasury bill, money market fund, or short-term CD) may be

a suitable investment vehicle. If the time horizon is ten years or more, an illiquid investment (such as real estate) may be suitable. It would have an expected rate of return that is higher than money market vehicles.

A consideration related to time horizons is an investment's volatility. The longer the time horizon, the less concern there is about an investment's short-term volatility. Goals with short time horizons require less volatile investments. Goals that have longer time horizons are better suited for investments like stocks and long-term bonds, which tend to be volatile. As the time to fund the goal approaches, however, it is usually advisable to acquire less volatile investments.

Liquidity

Clients with limited investments or those saving for a particular personal or business expenditure, such as a down payment on a home, will be concerned about the liquidity of their investments. They want to minimize delays and significant transaction costs if they decide to convert their investments to cash in the near future.

Marketability and liquidity are often confused. Marketability is determined by the speed and ease with which a security may be bought and sold. An actively traded stock that has a large number of shares outstanding is highly marketable and may be liquid.

Liquid assets can be readily converted into cash without significant loss. They include short-term government securities, money market funds, and savings accounts. Having liquidity in a portfolio means being able to take advantage of new market or business opportunities in a short period of time.

CPAs try to understand their clients' feelings about liquidity. Some clients need a great deal of liquidity to feel comfortable about their investment program. Others look at too much liquidity as costing them money. Illiquid investments typically provide a higher rate of return than liquid investments, so the investor has to consider the alternatives.

CPAs' recommendations about liquidity, other than establishing a reasonable emergency fund, are based on (1) the client's lifecycle position, (2) the client's near-term financial goals, (3) the rate of return required by the client to meet financial goals, (4) the client's wishes, and (5) the client's health.

The following investments are ranked in descending order of liquidity:

1. Savings accounts
2. Treasury bills
3. Certificates of deposit
4. High-grade common stocks
5. High-grade corporate bonds
6. High-grade tax-exempt bonds

7. High-grade preferred stock
8. Speculative common stock
9. Puts and calls
10. Futures contracts
11. Speculative corporate bonds
12. Speculative tax-exempt bonds
13. Real estate
14. Collectibles and physical assets
15. Limited partnership interests

Tax Considerations

Investment selection is influenced by a client's tax situation (that is, the tax bracket; alternative minimum tax preference items; available tax credits; and the amounts and types of income, deductions, and depreciation). The rate of return from an investment is a combination of (1) the tax benefits the client was able to use, (2) the type and amount of cash flow, and (3) the type and amount of final distributions. Certain investments make more sense for high-tax bracket clients, whereas others are more appropriate for low-bracket clients. High-tax bracket clients generally benefit more from tax-free, tax-sheltered, and tax-deferred income. The low-bracket clients usually benefit from high taxable income.

The determination of which investments will provide a higher return for a particular client requires the comparison of the investments' after-tax return. Thus CPAs often need to obtain knowledge about a person's tax situation to run "what if" tax scenarios comparing one investment with another.

CPAs will want to listen carefully to their clients' wishes or comments concerning tax matters and investments. To avoid worrying about an audit, some clients would rather pay high taxes than buy tax-advantaged investments.

Conversely, others may want to be more aggressive than is necessary. CPAs should not be so eager to crunch numbers and give clients all the correct mathematical answers that they forget to listen to their clients' constraints. (See the module titled "Income Tax Planning" for additional material on tax considerations.)

Estate planning concerns must also be considered. For example, decisions about whether to reposition elderly clients' investments, particularly those with a low tax basis, must consider the automatic step-up in basis that the investments will receive when the client dies.

Diversification

Diversification as an investment strategy is discussed later in this module (on page 3-6.32). Achieving adequate diversification, however, may be a constraint in selecting suitable asset categories. If a client's investments are primarily in one asset category, such as real estate, the planner would usually recommend investments in other categories to diversify the client's holdings. Some clients specifically state portfolio diversification as a major reason for wanting a financial plan. Others prefer to concentrate their investments in certain categories even though they understand the risks of not diversifying. Thus, a client's present holdings and preferences will govern how diversification is handled.

Size of Investment Units

Although not usually a major factor in choosing an investment, the size of an investment unit may sometimes affect asset choice. Private placement investments, for example, often require a $50,000 minimum investment. A round lot in bonds is 100 thousand-dollar bonds or $100,000. Smaller amounts are available but have a wider spread between their bid and ask prices. It is also easier to sell bonds in units of 100 because such transactions interest institutional buyers, not solely retail buyers seeking a particular issue.

Because transactions often have commissions, it is more expensive to buy and sell only a few shares or bonds at a time. Mutual funds are useful for clients who invest or withdraw small amounts of money.

Limited partnership investments have minimum requirements of $2,000 to $5,000, which might be more than a client has to invest at a particular time.

Use of Investments as Collateral

For some investors, the ability to use an investment as collateral is important because they may want the ability to borrow funds quickly to close a business venture. This procedure is easier if their investments are liquid or can be used as collateral. Small business owners sometimes use personal assets to borrow for working capital or inventory. Many investments can be used as collateral for loans. Lenders usually require that assets used as collateral have liquidity.

The following investments can easily be used as collateral:

- Stocks listed on an exchange, or traded over the counter and listed on NASDAQ
- Bonds of publicly traded companies and tax-exempt authorities with a BBB or Baa rating, or better
- Improved real estate
- Money market instruments, if the lender can hold the instrument or if an assignment is possible
- An assignment of the cash value of a life insurance policy

Investments that are not usually acceptable as collateral include the following:

- Shares of speculative or closely held companies
- Limited partnership interests
- Low-rated bonds
- IRAs, SEPs, Keogh Plans, and other qualified plan assets

Management Time

Depending on clients' investment strategies, investments vary in the amount of management time they require. Some, like certificates of deposit and short-term bonds, require very little management time. If clients are using dollar-cost averaging and a buy-and-hold strategy, their management time may be limited, even if their investments include direct investments in stocks and long-term bonds. However, if such investments are held directly, clients usually devote time to researching market performance, economic indicators, as well as the performance of economic indicators, and the performance of individual companies. Tangible property owned directly, such as rental real estate, sometimes requires substantial management time.

In selecting suitable investments, some clients consider how much management time their heirs will need to handle investments passed to them. If clients or their heirs do not have an interest in, or the adequate time for, managing investments, they may choose from several available options. For example, they can limit their investments to those that require little management effort; they can invest in a managed pool of assets, such as a mutual fund or a limited partnership; or they can arrange for management services, such as the services of a money manager or a property management company.

Client's Procrastination

Often, clients' constraints are not immediately evident. As their financial plans evolve, they may be better able to form opinions on financial matters. The process depends on clients' temperaments and interest in financial matters.

Clients' procrastination might be the biggest constraint that CPAs face. Procrastination in making an investment decision usually occurs because the choices are not in the clients' comfort zone for risk. At times it may appear that clients are fearful of making a wrong investment decision, but that could probably be attributed to their feeling uncomfortable with the risk involved.[4]

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[4] The preceding material on the time horizon, liquidity, tax considerations, diversification, size of investment units, use of investments as collateral, and management time is from Analyses and Role of Investments in Personal Financial Planning, P.6 Reprinted by permission.

STEP 6--RISK AND RETURN CHARACTERISTICS OF CLIENT'S CURRENT INVESTMENTS

Investments usually demonstrate a risk and reward relationship. The greater an investment's risk, the greater its reward should be. For example, as shown in the investment pyramid on page 3-6.13, when moving down from the top of the triangle to its base, the investment classes are arranged in order of decreasing riskiness of returns. Consequently, the investment classes are also arranged in order of decreasing expected returns. An investor expects to receive less return when assuming less risk.

CPAs are interested in the risk and return characteristics of their clients' current portfolios, which includes financial goals and risk tolerance. They will need this information when considering whether the investments are suitable.

The return on investments can be calculated from information about cost and income received from clients. Return information on many investment vehicles is also available from published sources.

Investment Risk

Investment risk is the likelihood that an investment's actual return will differ from its expected return. It is usually measured by the standard deviation of the investment's historical returns. A standard deviation is a measure of the variability of an investment's actual returns from its average return. Standard deviations on many investment classes are available from published sources. Investment risk can be divided into two parts: systematic risk and unsystematic risk.

Systematic Risk. This is the risk common to all securities of the same asset class, such as stocks or bonds, and thus cannot be eliminated by diversification. It is caused by economic, sociological, and political factors and includes market risk, interest rate risk, and purchasing power risk.

Market Risk. This is the tendency of prices of securities to fluctuate in relation to the securities market as a whole. An investor may buy the common stock of a company with improving earnings and an improving financial position. If the market declines, the market price of the stock may fall. Thus, even if clients select the stock of promising companies, they may still experience a decline in the price of the stock if their market timing is bad.

Interest Rate Risk. Interest rate risk is the tendency of prices of fixed-income and yield-sensitive securities to fluctuate in response to changes in the general level of interest rates. A rise in the level of interest rates generally causes a decline in the market prices of fixed-income securities. Conversely, a decline in general interest rates tends to cause an increase in the market prices of existing fixed-income securities. The longer the time until

the security's maturity, the greater the impact of a change in interest rates on the security's price.

Fixed-income securities promise the investor a periodically stated amount of income. They include preferred stocks, convertible preferred stocks, corporate bonds, convertible corporate bonds, tax-exempt bonds, bond funds, U.S. Treasury obligations, and mortgage-backed securities. Interest rate risk also affects yield-sensitive common stocks (such as utility stocks) that are bought primarily for their annual dividend or percentage of yield. The effect of interest rate risk can be illustrated by the following sample bond:

Cost: $1,000
Maturity: 30 years (25 years remaining)
Coupon: 5% or $50-a-year interest

Five years later, interest rates have increased so that newly issued bonds have a 10 percent yield to maturity. To be competitive, the illustrated bond has to be priced to yield a 10-percent return over its twenty-five remaining years. The price can be computed using a calculator and the procedure for computing the present value of a bond. Alternatively, it can be computed using present value tables.

Price = Cost x Present value of face amount of bond + Interest payments
x Present value of the stream-of-interest payments

The following adjustments are required because the interest payments are semiannual:

- The number of periods: (Years remaining to maturity x 2) = 25 years x 2 = 50
- The discount factor: 10% ÷ 2 = 5%
- Interest payments: (Face x Stated interest ÷ 2) = 1000 x .05 ÷ 2 = $25

Price = 1000 x Present value factor for 50 periods at 5% (table 1 in the appendix)
+ $25 x Present value-of-an-annuity factor for 50 periods at 5%
(table 3 in the appendix)

$543 = 1000 (.087) + 25 (18.256)

Because the length of time to maturity affects how much a bond's price changes when the general level of interest rates' change, the change in interest rates after five years would

have the following, less dramatic effect on the price of the bond, if the bond had a maturity of seven years when purchased:

- The number of periods: 2 years remaining x 2 = 4
- The discount factor: 10% ÷ 2 = 5%
- Interest payment: $25

Price = 1,000 x Present value factor for 4 periods at 5%
(table 1 in the appendix)

+ $25 x Present value-of-an-annuity factor for 4 periods at 5%
(table 3 in the appendix)

$912 = 1,000 (.823) + 25 (3.546)

The change in interest rate from 5 percent to 10 percent reduced the price of the bond with twenty-five years to maturity to $543, but only reduced the price of the bond with two years to maturity to $912.

The company or tax-exempt authority that issued the bond may still be in excellent financial condition, but the upward movement in the general level of interest rates has caused the bond to lose value in the marketplace. All fixed-income securities of the same quality tend to move up or down in unison.

If the fixed-income securities are acquired to fund goals, interest rate risk can be minimized if the maturities of the investments correspond to the time when the funds will be needed. Interest rate risk is not an issue if securities are held to maturity. Before adopting such a strategy, however, other considerations may need to be addressed, such as whether the strategy poses an unacceptable risk of loss of purchasing power.

Purchasing Power Risk. Purchasing power risk refers to the effect of inflation and disinflation on the future purchasing power of the income and principal from an investment. The bond in the previous illustration will mature at $1,000 in thirty years. During that period, if the annual compounded inflation rate is 6 percent, the value of the principal can be computed as follows:

Future value = Face amount x Present value factor for 30 periods at 6%
(table 1 in the appendix)

$174 = 1,000 x .174

If the $1,000 principal will be worth only $174 at maturity, the principal will lose $826 ($1000 - $174) in purchasing power over thirty years.

The nominal return on an investment is the stated or market interest rate. It is not adjusted for inflation.

A real return is the return after taxes and inflation. If inflation is 6 percent and the investor is in a 35-percent tax bracket, the real after-tax return on the 5-percent bond illustrated previously is negative 2.75 percent.

Persistent inflation over a long time period leads many investors to seek investments they believe will offer protection from severe declines in purchasing power. The effect of disinflation on purchasing power is not widely discussed in textbooks. Disinflation is the reversal of inflationary pressure, which causes a decrease in the inflation rate. Many people tend to think of disinflation as positive for stocks, bonds, and savings accounts. It can, however, cause price declines, and therefore a loss of purchasing power, in other investments until inflation and prices stabilize. This risk occurs in disinflationary periods (for example, 1980 to 1983), when assets that hedge inflation -- real estate, gold, silver, diamonds, and collectibles -- fell in price as inflation declined.

Unsystematic Risk. Unsystematic risk refers to risks that are associated with the nature of the business underlying the investment. It can be divided into two types of risk: business risk and financial risk.

Business risk. Business risk is associated with the nature of the enterprise itself. Businesses are not equally risky. They are affected to varying degrees by factors such as government regulation, market competition, changes in tax law, disasters, management's ability, operating costs, and consumer preferences. The extent to which businesses are subject to these factors, and their ability to handle them, cause similar businesses or properties to have considerably different levels of business risk.

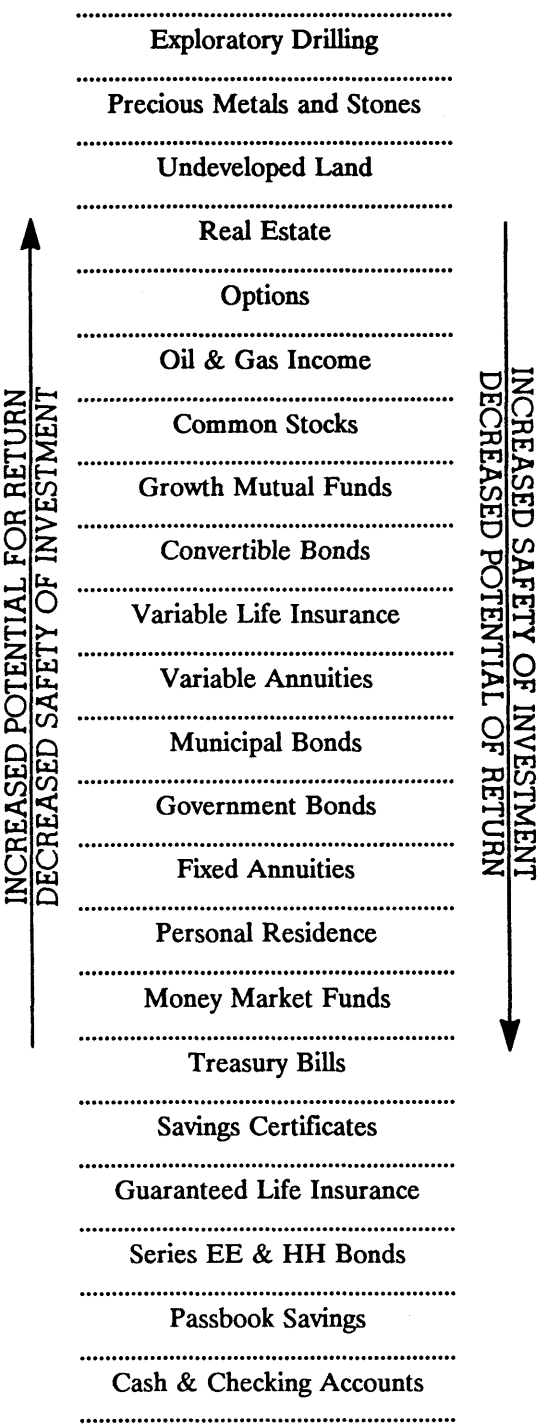
Financial Risk. Financial risk is associated with the combination of debt and equity used to finance a firm or property. The more debt used, the greater the financial risk. A highly leveraged piece of property has financial risk because of the large payments required to service the debt. Any sudden decrease in occupancy or patronage might force the property into foreclosure. A firm or property with no debt has no financial risk.

Unsystematic risk can be avoided by diversification. Studies have shown that the unsystematic risk in common stocks is practically eliminated by holding as few as eight to ten stocks.

Risk and Return

The riskier an investment is, the greater will be the return that investors will require as an incentive to invest in it. The start-up phase of a consumer products company, for example, may include high business risk. Investors would, therefore, require a high return on their investment in the firm. In contrast, U.S. Treasury bills have little market, business, interest rate, or purchasing power risk. Their average yield in the last sixty years is 0.3 percent over the average inflation rate for that period. Exhibit 3-6B lists investments in order of decreasing riskiness of returns. Investments at the top of the ladder should offer the possibility of significantly greater rewards than those at the bottom.

THE RISK-RETURN LADDER



Robert T. LeClair, A Consumer's Guide to Investing for Financial Independence. Reproduced with permission. Longman Financial Services Institute, Vernon, CT.

The Effect of Investment Risk on Asset Classes

The table on the next page illustrates how various investment risks usually affect investment vehicles in different asset classes over reasonable periods of time. The chart is very broad and is not meant to be an investment tool. Financial risk is not shown because such risk is an individual issue based on the amount of leverage used by a business or used by an individual to purchase an asset or investment.

The ranking system is subjective; individual situations vary from this generalization of how certain risks affect various investments. The chart is most helpful when used in conjunction with economic information (especially inflation projections) and the clients' investment strategies. It may help CPAs to develop investment plans that protect clients from various types of investment risk.

Although investment risk encompasses many different types of risk, most clients do not care about the components of risk, but are simply aware that risk, from whatever source, involves a chance of experiencing a loss. Although the U.S. Treasury bill is often referred to as a risk-free investment, it is subject to purchasing power risk and interest rate risk if sold prior to maturity. A money market account is always priced at $1 a share, but it too is subject to a small loss in purchasing power each month. Thus, no investment is absolutely risk-free.

THE EFFECT OF INVESTMENT RISK

Interest Purchasing Power Risk

	Market Risk	Rate Risk	Inflation	Dis-Inflation	Business Risk
Money Market CDs	0	0	*	+	0
Money Market Accounts	0	0	0	0	0
U.S. T-bills	0	*	*	+	0
Fixed-Income					
U.S. govt. bonds	*	*	*	++	0
Corporate bonds	*	**	**	++	*
Tax-exempt bonds	*	**	**	++	0
Preferred stock	*	**	**	++	*
Common Stock					
Income	*	*	*	+	*
Growth	*	0	+	*	*
Puts and calls	**	0	*	0	*
Real estate					
Residence	0	*	+	*	0
Income property	0	*	+	*	*
Raw land	0	*	+	*	*
Collectibles and Physical Assets					
Gold, silver	*	0	+	*	*
Antiques	0	0	+	*	0
Commodity futures	**	0	+	*	**
Other Investments	0	0	+	*	*
Oil and gas	0	*	+	*	*
Equipment leasing					

Ranking Key:

++ = Very beneficial
\+ = Beneficial
0 = Little or no change
* = Detrimental
** = Very detrimental

STEP 7--ADEQUACY OF RESOURCES

At this stage in the process, CPAs have all the information needed to calculate the amount required to fund each of their clients' goals: the amount required in today's dollars, the time frame, the savings and cash flow available for investment, the financial assumptions, and the clients' risk tolerance.

The goals-funding calculation is a present-value computation that can be made using financial tables or, preferably, a financial calculator. (Goals-Funding worksheet exhibit 3-6X.1) is a tool for computing the funding required for each goal, using the present- and future- value tables in the appendix.)

After CPAs calculate the funding required for clients' goals, they compare the funding requirements with the available investment assets and discretionary cash flow (see exhibit 3-6X.2). Goals can be funded separately, with the investments earmarked for specific goals. Alternatively, certain investments may be earmarked to fund several goals, or the client's portfolio may be considered as a unit for funding all the client's goals.

The CPA can review a summary worksheet (such as exhibit 3-6X.2) and the client's current portfolio to evaluate whether the client's overall investment portfolio will be adequately diversified (see the discussion of diversification on page 3-6.32).

If resources appear to be inadequate, clients have the following options:

- Allocate additional assets to meet their financial goals, which may require converting nonworking assets to investment assets.
- Reduce living expenses to increase discretionary cash flow.
- Increase earned income.
- Extend the time frame for achieving the goals.
- Consider accepting additional risk and funding goals with investments that have higher expected returns.
- Revise goals, such as considering to purchase a smaller home.
- Reconsider their priorities and postpone or eliminate certain goals.

CPAs can discuss the available options with their clients, evaluate the risks and trade-offs involved, and establish revised goals and strategies as needed. CPAs analyze the appropriateness of the client's current investment strategies by considering the nature of the goals and the time frame to determine if the investment risk is reasonable. The return is evaluated to see if it is adequate to meet the client's funding requirements.

STEP 8 -- FINANCIAL ASSUMPTIONS

The selection of financial assumptions is a key element of the investment process. The sensitivity of financial assumptions is directly related to the length of the funding period. The compounding of inflation and investment return over a long period has a greater effect on the ultimate result than it would have over a short-term accumulation period. Even though it may be more difficult to make reasonably accurate assumptions over longer periods, monitoring assumptions and making appropriate adjustments on a periodic basis reduces the likelihood that clients will have insufficient funds to carry out their goals.

The inflation assumption is usually the starting point in developing financial assumptions. The relationship of investment returns to the inflation rate, particularly over the long term, is more predictable than the inflation rate itself. If clients tie their assumed investment return to the inflation rate (for example, specifying an investment return at 3 percent over the inflation rate), the significance and impact of the inflation rate assumption is reduced.

The following table indicates that the average U.S. inflation rate, as determined by the consumer price index (CPI), has been steadily increasing. It also indicates that the ranking of security returns has, for the most part, remained reasonably constant. The following information was derived from Stocks, Bonds, Bills and Inflation, 1988 Yearbook by Ibbotson Associates of Chicago, Illinois.

AVERAGE ANNUAL COMPOUND RETURN

	1926-1986	*1946-1986*	*1970-1986*
Inflation (CPI)	3.0%	4.5%	6.5%
U.S. Treasury bills	3.5	4.6	7.7
Long-term government bonds	4.4	3.8*	--
Long-term corporate bonds	5.0	4.8	9.7
Common stocks	10.0	11.4	10.6

**Through 1985*

The investments included in the table on the right are listed in increasing order of risk and return. Investors demand higher returns on investments with higher risk. Investments with greater volatility in their returns, such as common stocks, tend to have higher returns than investments with lower volatility in their returns, such as U.S. Treasury bills. Consequently, as clients try to increase their investment return, they may also increase the risk that their actual return will differ from their expected return. Diversification, however, (see page 3-6.20), may enable clients to increase their overall return without increasing risk, or it may permit clients to reduce their risk without reducing their overall return.

One trend suggested by the foregoing table is that, historically, inflation rates have been steadily increasing. In deciding on the inflation assumption to use in projections, CPAs and clients discuss historical information and current trends.

If a client is comfortable with the concept and historical data on average returns, such as shown in the foregoing table, then it can be used as a guideline for developing assumptions about rates of return on long-term investments. Whenever historical data is chosen, the CPA should make clear to the client that past returns are no guarantee of future performance. The historic difference between the rate of inflation and the return on investment can be added to the client's assumed annual inflation rate. This method is illustrated in the following chart, which uses 1926 - 1986 average annual compound returns. The client and the planner, however, may decide that the use of returns reflecting other periods is appropriate. Numerous returns are available for longer, shorter, and more current periods.

FORMULA USING 1926-1986

Item	*Historical*	*Projected Investment Return*
Inflation	Established by client	6.5%
U.S. Treasury bills	Client's inflation (6.5%) + Real interest rate (3.5%) - (3.0%) = (.5%)	7.0%
Long-term government bonds	Treasury bills (7.0) + maturity premium (4.4%) - (3.5%) = (.9%)	7.9%
Long-term corporate bonds	Long governments (7.9) + default premium (5.0%) - (4.4%) = (.6%)	8.5%
Common stock	Treasury bills (7.0%) + equity risk premium (10.0%) - (3.5%) = (6.5%)	13.5%

STEP 9 -- INVESTMENT PLANNING SERVICES

Once it is determined that the goals are within clients' ability to fund them, CPAs develop recommendations. They may identify the existing assets that will be reserved for funding specific goals, periodic amounts that need to be invested, and the rates of return required. CPAs then provide the agreed-on level of investment planning service, which may include--

- Providing general guidance regarding investment strategies.
- Providing specific guidance regarding investment asset allocation strategies.
- Recommending specific investments.

As discussed on page 3-6.53, the level of service provided may affect whether the CPA is required to register as an investment adviser.

General Guidance Regarding Investment Strategies

If CPAs' services consist of providing general guidance regarding investment strategies, CPAs will try to educate clients by suggesting several suitable investment categories. They may explain risk and return concepts by using charts (such as page 3-6.33) that provide historical information for different investment classes.

CPAs may discuss with their clients one or more investment strategies designed to improve returns, reduce risk exposures, or both. The techniques used to implement the investment plan may be applied directly by the investor, or on behalf of the investor by a broker or money manager. Several basic investment strategies are described, in addition portfolio performance enhancement strategies of leverage, covered call options and put options are described.

Diversification. Diversification can be used in conjunction with other strategies. It can be applied to a portfolio in terms of asset classes, industries, issuers, maturities, quality, and timing.

Investors seek investment portfolios that will maximize their return for the amount of risk they are willing to assume. Optimal returns may be obtained by assembling portfolios of investments that have minimally positive, or perhaps even negative, correlation. Positive correlation is the extent to which the total returns of different assets move similarly in response to changes in economic, political, and sociological conditions. If investment returns are not positively correlated, a portfolio will experience less variability of returns as conditions fluctuate. Thus, the old adage "Don't put all your eggs in one basket", may hold true in investment planning. For example, even though a client whose portfolio consists entirely of tax-exempt municipal bonds which may have an enviable marginal tax rate, fluctuations in the level of interest rates might cut his or her net worth in half.

CPAs frequently work with clients whose investments consist almost entirely of their small businesses, farms, or employers' corporate stock. Changes in the national or local economy, changes in a particular industry, or other conditions might decrease the value of certain businesses, farms, or corporations. CPAs may be able to convince such clients of the need to diversify their investments. Certain obstacles, however, may have to be overcome. A corporate executive, for example, may be blind to the corporation's problems or not be able to objectively evaluate the investment potential of its stock. The executive may be reluctant to sell corporate stock because of a sense of loyalty, political pressures, fear of appearing unenthusiastic about the corporation's future, or tax considerations. Executives who are insiders must also comply with SEC regulations regarding sales of company stock.

Diversified portfolios may yield higher returns and reduce variability if they do not contain perfectly positively correlated investments. Diversification may therefore help clients sleep at night. The wide swings in market conditions, interest rates, and rates of inflation in recent years have practically reversed the relative returns of various investments, as shown in the following chart.

Investments that flourish in an inflationary environment may have negative returns when disinflation occurs. Broad diversification may thus be necessary, perhaps including even a small holding of precious metals as a hedge against high inflation.

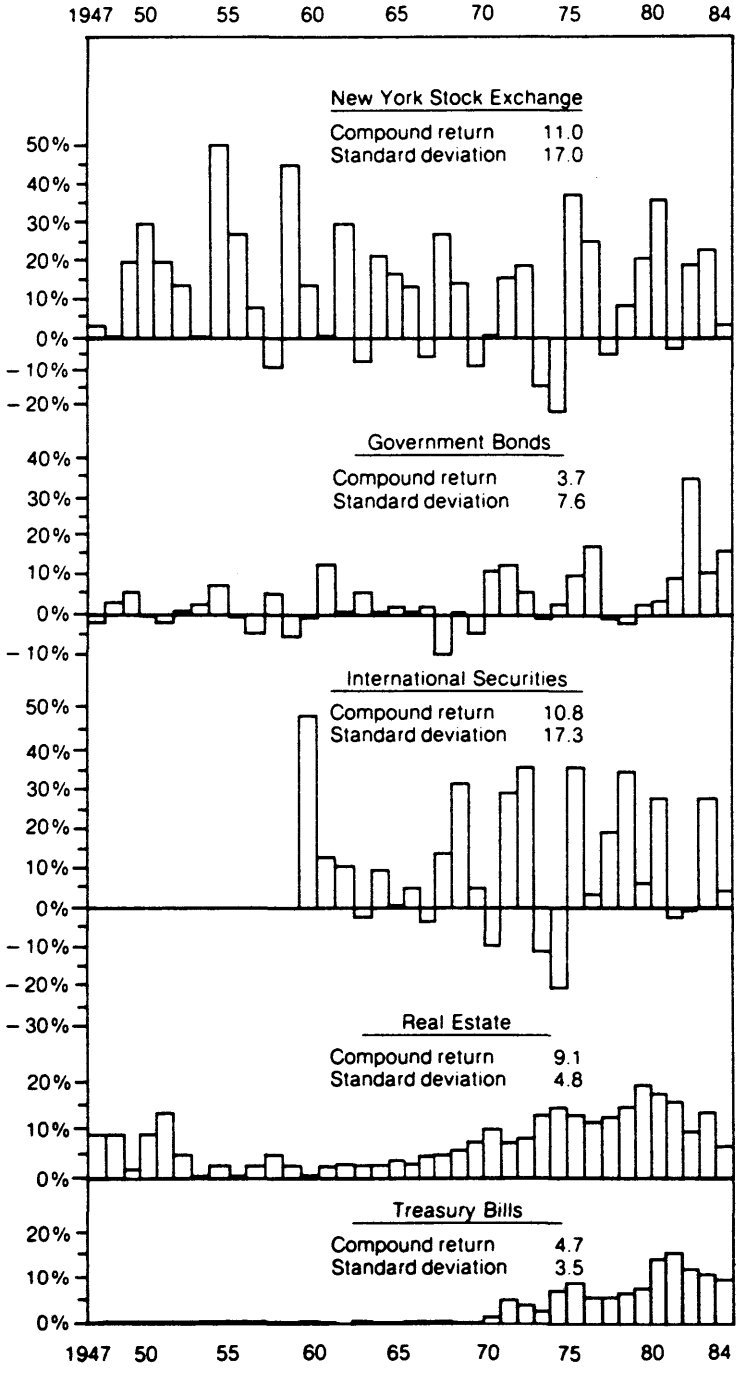
Exhibit 3-6D depicts the total returns from 1947 to 1984 of five investment categories and a hypothetical diversified portfolio containing 20 percent of each investment category. Compared with the graphs of the individual investment categories, the graph of the hypothetical portfolio has less variability of returns and fewer negative returns than some of the asset categories, especially when compared with New York Stock Exchange equity securities.

ANNUAL RATES OF RETURN AND RANK

	June 1970 to June 1980-- Average Annual Return		June 1980 to June 1985-- Average Annual Return	
	%	*Rank*	%	*Rank*
Oil	34.7	1	-5.4	9
Gold	31.6	2	-11.0	10
Stamps	21.8	3	0.1	7
Diamonds	15.3	4	1.2	6
Farmland	14.0	5	-1.7	8
Housing	10.2	6	4.3	5
Consumer price index	7.7	7	5.7	4
Treasury bills	7.7	8	12.0	3
Bonds	6.6	9	13.2	2
Stocks	6.1	10	15.2	1

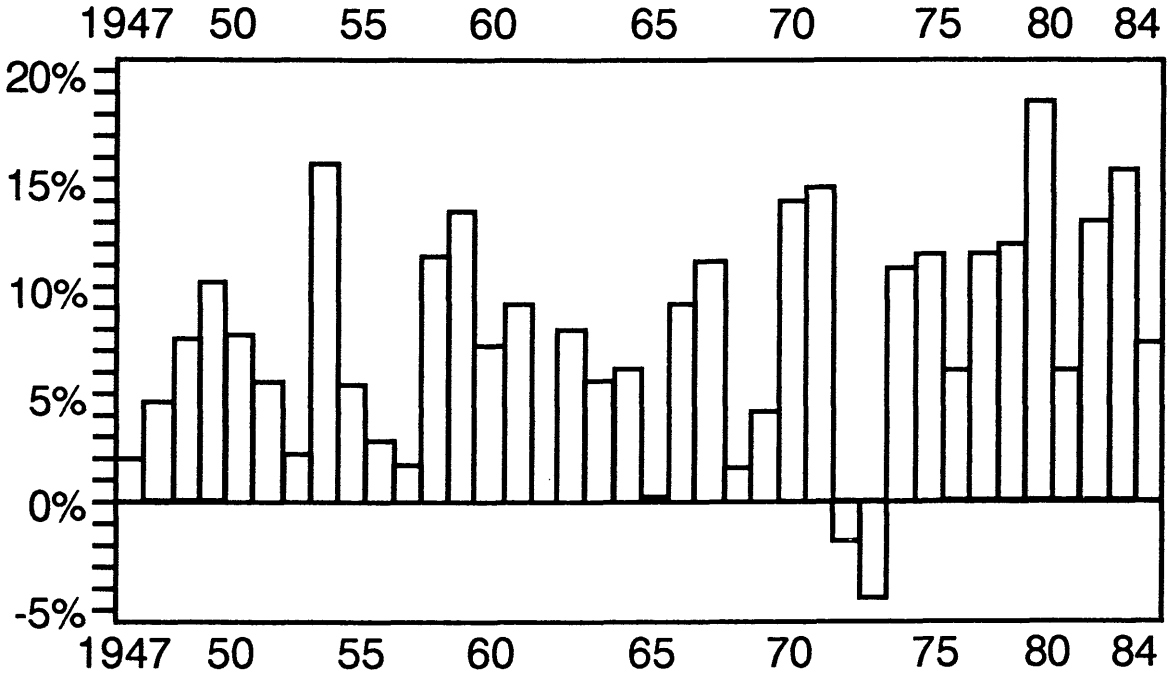
Source: The Institute of Chartered Financial Analysts, Asset Allocation for the Individual Investor (Homewood, Illinois: Dow Jones-Irwin, 1987). Used with permission.

PERFORMANCE OF FIVE ASSET CLASSES



Source: Bailard, Biehl & Kaiser Communications Group

A PORTFOLIO OF 20 PERCENT OF EACH ASSET CLASS



Source: Bailard, Biehl & Kaiser Communications Group

Source: The Institute of Chartered Financial Analysts, Asset Allocation for the Individual Investor. Homewood, Illinois: Dow Jones-Irwin, 1987. Used with permission.

Passive Management -- Buy and Hold. The investment strategy of buying securities and holding them for long periods of time reduces transaction costs and allows market trends to operate. This strategy also minimizes management time and expertise and helps discourage the individual investor's tendency to "buy high and sell low." Research indicates that actively managed portfolios do not outperform passively managed portfolios, and in fact, studies by William Kaufman and Philip Goldstone indicate that rebalancing portfolios may actually reduce performance over time. (See "Let it Ride" by William Kaufman and Philip Goldstone, Financial Planning, December 1988, pp. 84-87.)

Active Management Strategies. Active portfolio management involves making relatively short-term adjustments that are designed to "beat the market." These transactions involve liquidating investments in asset classes that are believed to be less attractive and increasing investments in those classes believed to be relatively more attractive for the foreseeable future. Active portfolio managers are often contrarians who move investments into those asset classes currently out of favor in anticipation of market changes. Another justification for active management is diversification because -- absent periodic asset redistributions -- portfolios tend to become less diversified as certain asset classes increase more rapidly than others.

Active portfolio management is more costly than passive management. It involves more transactions, research costs, and fees for professional advice than a buy-and-hold strategy. Consequently, gross returns with active management must be superior to those with passive management, or the resulting portfolio will underperform a passively managed one.

Dollar Cost Averaging. This approach involves investing a constant dollar amount at regular, such as monthly or quarterly, intervals. Dollar cost averaging constitutes a diversification in timing, which results in more securities being purchased when prices are low and fewer when prices are high. This strategy works in rising, falling, and fluctuating markets to produce average costs per share that are less than the ending market price per share. The key to the successful use of the dollar cost averaging approach is discipline. However, although this strategy is simple and easy to apply, it does not advise on when to sell securities.

Value Averaging. Value averaging differs from dollar cost averaging by requiring a fixed increase in the value of the portfolio each period. Consequently, under the value averaging approach, more shares are purchased in periods when market prices decline, fewer shares are purchased when market prices increase, and large price increases result in the sales of securities.

Actual market price movements can cause a dollar cost averaging strategy to produce a better internal rate of return than a value averaging strategy. However, studies by Michael

E. Edleson, described in the August 1988 issue of the AAIA Journal, show that value averaging outperforms dollar cost averaging more than 90 percent of the time.

Because value averaging involves an analysis of the portfolio value for each period, it is more difficult to implement than dollar cost averaging. Value averaging also requires varying amounts of liquidity and can produce taxable income or loss more frequently than a dollar cost averaging strategy. However, these difficulties can be minimized by carrying over, rather than liquidating, securities that represent "extra value" under the value averaging approach. Tax implications of the value averaging approach can be avoided by applying the strategy in an IRA, Keogh plan, or other tax deferred arrangement, and transaction costs can be minimized by using no-load mutual funds that allow telephone transfers.

Notwithstanding its comparative advantages, value cost averaging is not appropriate if --

1. It results in odd-lot stock trading.
2. It requires more time to implement than the investor is willing to devote.
3. The investor is not able to preserve the excess value produced during rapidly appreciating markets for future use when larger purchases should be made.

Market Timing. Active portfolio management requires some use of market timing strategies, which are designed to allow the investor to be in the market during rising markets and out of the market during falling markets. This approach is frequently implemented with the use of a money manager who is a market timer or by subscribing to market timing newsletters.

Both approaches tend to use trend analysis to generate buy and sell signals by comparing moving averages to current market conditions. For example, if the current market price moves downward through a relevant moving average, a sell signal is generated. Similarly, if the current market price moves upward through a relevant moving average, a buy signal is produced. Moving averages are commonly based on fifty-day, 200-day, ten-week, thirty-nine week, or forty-week analyses, with some averages giving greater weight to more recent periods through the use of exponential smoothing. Other technical market indicators are sometimes combined with trend analysis to produce buy and sell signals. Most market timing strategies involve the use of one or more of the following techniques: business cycle anticipation, liquidity -- Federal Reserve policy -- anticipation, technical analysis, and comparative valuation of assets.

The disadvantages of using market timing approaches include the lack of assurance that a particular analysis will accurately predict future market movements, transaction costs associated with moving in and out of the market, and tax liabilities that may be created by such movements. In addition, most investors require professional assistance with the application of sophisticated market timing techniques.

In addition to basic investment strategies for determining the timing of investment purchases and sales, there are additional strategies that can be used that will affect the overall portfolio return. Three strategies are described below.

Leverage. Debt, or leverage, can be used to increase the profit potential of a portfolio, reduce the inflation risk of a portfolio, diversify a portfolio, or reduce the tax costs associated with particular investment strategies. The economic environment, the after-tax cost of debt, the investor's liquidity needs, and the investor's risk tolerance affect the appropriateness of using leverage.

Most securities can be used as security for debt; that is, they are marginable. Public limited partnerships and new-issue offerings are subject to special restrictions, but stocks listed on a national exchange or in the NASDAQ OTC Quotation System, listed corporate convertible and nonconvertible bonds, tax-exempt bonds, and U.S.-issued or backed securities are marginable. Rates on margin accounts are usually tied to the broker call rate, which is listed in the Wall Street Journal as "call money" and is similarly shown in other large metropolitan daily papers.

Nationally listed and NASDAQ stocks can be marginated at 50 percent of market value, listed convertible bonds are marginable at 20 percent of market value, and U.S. government bonds can be marginated at 10 percent of face value. Mutual funds can be marginated after they have been owned for at least thirty days, but this is not a common practice. In addition, the New York Stock Exchange requires that margin accounts be funded with a deposit of at least $2,000 or an equivalent amount of fully paid securities listed on the NYSE. Similarly, the National Association of Securities Dealers requires an initial deposit of $2,000 in cash or fully paid securities listed in its OTC Quotation System.

Additional security must be provided if debt exceeds the specified percentage of the value of securities held in a margin account. If the value of securities in the account falls enough so that debt being secured by them exceeds the relevant percentage of their market (or face) value, the investor will receive a margin call and be required to provide more cash or securities. Individual firms may require higher margin requirements.

Covered Call Options. Investors who want to enhance their potential returns from securities held in their portfolio may decide to sell (write) call options on them. This approach, referred to as "writing covered call options", produces premium income for the investor, thereby enhancing the current return produced by the portfolio. However, if the price of the stock increases past the strike price of the call option, the investor may be forced to liquidate his or her existing holdings or purchase new holdings on the open market at prices exceeding the payments he or she will receive from the purchaser of the call.

Consequently, this strategy increases the riskiness of the investor's portfolio management strategy.

Put Options. Investors who want to own stocks in their portfolio but are concerned about possible major market moves in the short term, can hedge their portfolios by purchasing put options. These options can be purchased on some individual stocks, but it is more common to purchase put options on the S&P 500 Index or similar indexes. If options on an index are going to be purchased, an index that closely tracks the investor's portfolio should be selected.

The premium paid when purchasing a put option is, in effect, insurance against major market downturns during the period of the option contract. It is not practical to permanently insure portfolios by continually buying options, but for avoiding certain short-term market risks, puts offer an effective alternative to selling stocks.

Specific Guidance Regarding Asset Allocation Strategies

Investment planning service may include providing clients with asset allocations. The objective of asset allocation is to use investable resources to satisfy the client's goals and objectives. It includes identifying asset classes that meet clients' investment constraints. The expected return, risk, and correlation of those asset classes are determined, and an asset mix that has an expected return equivalent to the yield required to satisfy the client's goal is decided on. This is a mix that is likely to enable the client to meet his or her goals while minimizing risk. If it is not possible to satisfy the goals without assuming more risk than the client is comfortable with, the client may have to reconsider his or her goals or allocate additional resources to achieve them.

After the asset mix is determined, the client or investment manager selects specific investments according to the asset mix decision, with a view to achieving diversification within the asset categories as well as among the investor's overall investments. The portfolio can then be managed either actively, to take advantage of market indicators, or passively, adjusting only to rebalance the portfolio or because of a change in circumstances. The investment results are measured and the portfolio is adjusted as required to meet the client's objectives. See Exhibit 3-6E for a chart of asset allocation process.

Selecting Suitable Asset Categories. The asset mix decision requires the selection of asset classes that are suitable investments for funding one or more of the client's goals. See Exhibit 3-6F for a chart of an asset allocation model which is designed to help clients select asset classes. Asset classes are grouped into two broad categories: fixed-income and equities. Within each asset category, the asset classes are generally arranged from left to right in order of increasing risk, with the least risky assets on the left. Within each asset class, investment vehicles are again listed in order of increasing risk beginning with the least risky at the top. Theoretically, the investment appearing in the lower right corner of the page would be the most risky investment in the portfolio category. This is an oversimplification, however.

For example, a municipal bond may have a C++ rating, indicating it may be in danger of default. This bond would be listed near the bottom of the municipal bond asset class

column. A corporate bond with an A rating would be listed near the top of the corporate bond-class column. Corporate bonds are positioned as a more risky security than municipal bonds within the main category. The municipal bond, however, would be substantially more risky than the high-grade corporate bond.

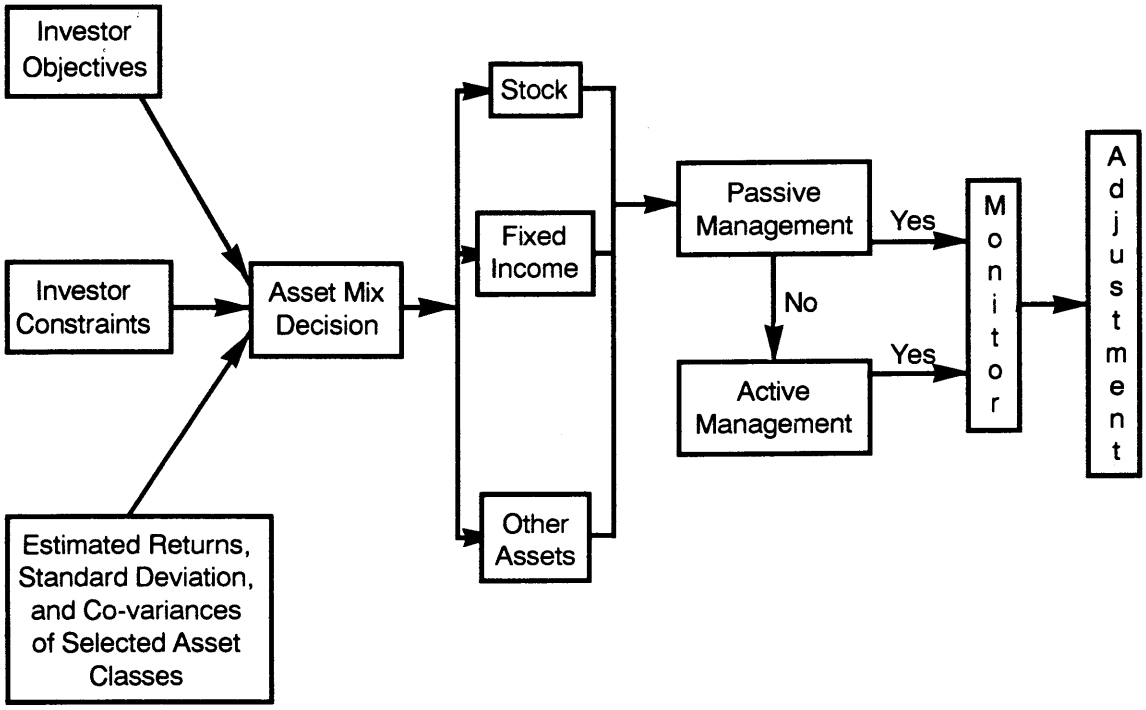
The asset allocation model in exhibit 3-6F helps place assets in classes of varying amounts of risk. This classification procedure highlights the amount of risk that may be present in a securities portfolio; it may indicate a need to reposition the portfolio to comply with the client's investment goals and objectives.

The suitability of an asset class will depend on its characteristics. An asset's expected rate of return is an important characteristic that is estimated by using one or more of the following factors: historical returns, the inflation situation, and economic indicators. The historical return will depend, in part, on the time period being considered -- whether it is the longest possible period, the most recent period, or all possible periods of the same length as the funding period (for example, all ten-year periods). Historical return information is useful if the client will use a long-term buy-and-hold investment strategy.

The risk associated with an investment category or class is often estimated by the standard deviation of the investment's historical returns. A high standard deviation means an asset has volatile returns. Investors holding securities with high standard deviations have more risk that their actual returns will differ from the expected return.

Investor Constraints. To identify asset categories suitable to fund particular goals, CPAs need to consider their client's investment constraints, such as their time horizon, life-cycle position, risk tolerance, liquidity needs, tax considerations, cash flow needs, and diversification requirements. (See the discussion of risk tolerance on page 3-6.08 in this module.)

A FLOW CHART OF THE ASSET ALLOCATION PROCESS



(Adapted from Investment Analysis and Portfolio Management by Jerome B. Cohen, et al. Homewood, Ill.: Irwin, 1982, p. 562.)

Asset Allocation Model
Fixed Income Section

Asset Allocation Model
Equities Section

MUTUAL FUNDS	NYSE-ASE INCOME COM. STKS.	NYSE-ASE GROWTH COM. STKS.	OTC COMMON STKS.	OTC/REGIONAL SM COMPANY STK.	INTERNAT'L COM. STKS.	DIRECT OWNERSHIP RESID. R/E	DIRECT OWNERSHIP COMMER. R/E	COLLECT-IBLES	LTD/SYND PART. R/E OIL & GAS LEASING	OTHER
← INCREASING RISK →										Commodities
Balanced Funds	Utilities	Low Div.				Single Fam.	Office Space	Antiques		
Moderate Risk Funds	Non-Utility Income	Beta >1				Duplex	Retail Space	Dir. Ownership Precious Metals		Naked Options
Agressive Growth Funds		Rel PE >1				Condo	Warehouse	Art & Art Objects		Futures
Emerging Companies Funds		Fin Stgh <6				Apartment House		Stamps		
International Funds								Precious Stones		
Other Specialty Funds								Other Collectibles		
Actual Percent to Total										
Recommended Percent to Total										

Correlation of Returns. A stock's beta coefficient is a measure of the volatility of a particular stock relative to the volatility of the market as a whole. It is an index of a stock's systematic risk. A beta coefficient of 1 means that the stock's return moves exactly with an index of the market. Aggressive stocks have betas of more than 1, meaning that their returns are more volatile than the market's returns; they have higher returns in rising markets and lower returns in falling markets.

In contrast, alpha is the amount of a stock's return that is independent of the return on the market. It measures factors other than movements in the overall market that cause the stock to have a higher (positive alpha) or lower (negative alpha) rate of return than another stock that has the same beta.

Exhibit 3-6G summarizes the annual returns and standard deviations of various asset classes from 1926 through 1987.

The historical risk and return relationship is not necessarily a predictor of future risk and return. The prospects for future risk and return are considered to the extent information is available. Other risks to consider when evaluating an asset category include its market risk, purchasing power risk, and interest rate risk. (See the discussion of investment risk in this module.)

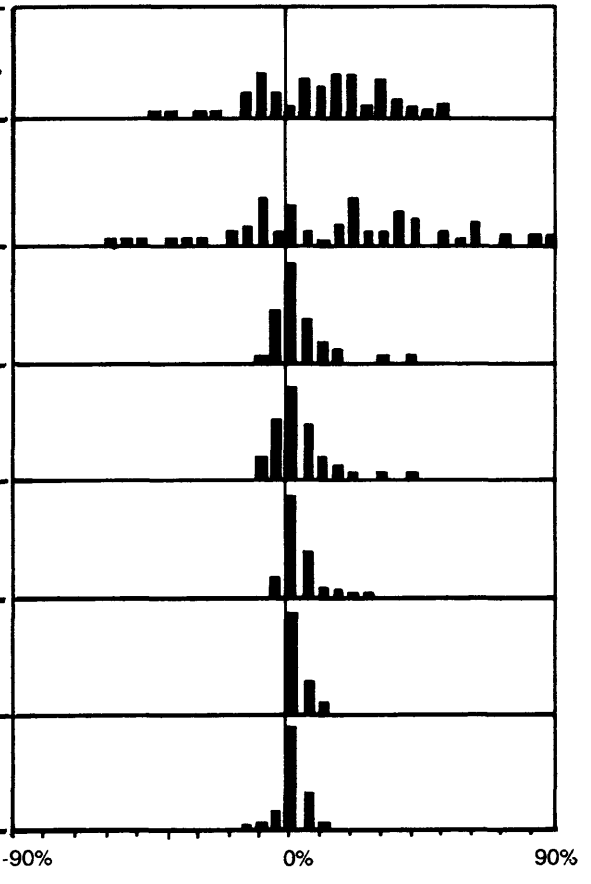
The suitability of an asset category will depend, in part, on the correlation of its return with that of other investments. It may offer desirable diversification if its returns are not correlated with other investments. Assets may be selected to fund individual client goals or to meet the funding requirements of all goals, but in either case, adequate diversification of the overall portfolio is a consideration. Other characteristics to consider in selecting asset categories are the asset's tax attributes and expected cash flow, the amount of time required to manage the asset, and transaction costs.

Trends in the economic environment can affect the expected returns, risk, and correlation of asset categories. Factors to consider include trends and forecasts of economic growth, inflation, interest rates, energy costs, fiscal and monetary policies, and financial market indexes. Factors that indicate business cycle trends include housing starts, auto sales, inventories, and the unemployment rate. The suitability of an asset category also depends on the goal being funded -- its time frame and importance to the client.

The selection of suitable investments can be documented by indicating the basis for estimates of the rate of return, risk, and correlation coefficients. Other factors contributing to the selection can also be described.

Basic Series: 1926 - 1987
Summary Statistics of
Annual Returns

Series	Geometric Mean	Arithmetic Mean	Standard Deviation
Common Stocks	9.9%	12.0%	21.1%
Small Company Stocks	12.1	17.7	35.9
Long-Term Corporate Bonds	4.9	5.2	8.5
Long-Term Government Bonds	4.3	4.6	8.5
Intermediate-Term Government Bonds	4.8	4.9	5.5
U.S. Treasury Bills	3.5	3.5	3.4
Inflation Rates	3.0	3.2	4.8



The Asset Mix Decision. A study of the investment results of large pension funds over a ten-year period revealed that between 75 percent and 98 percent of the funds' total return resulted from asset allocation (that is, the asset classes in the portfolio and their relative weights) (Determinants of Portfolio Performance, Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, Financial Analysts Journal, July-August 1986, pages 30-44). Market timing and specific security selection accounted for a relatively small part of the total return. The asset allocation decision is therefore a key to investment performance. Consequently, planners need a thorough understanding of the characteristics of asset categories, including sources of information concerning return and risk.

Some CPAs find that economic forecasts are not essential for investment planning because portfolio return depends primarily on asset allocation rather than market timing or security selection. Further, consistently reliable economic forecasts are not available, even to large institutional investors.

Asset allocation is a strategy that uses diversification of assets to reduce overall portfolio risk. Its purpose is to provide some protection from market volatility, not to obtain the optimum return. Most clients are risk-averse and will understand and appreciate the concept of diversification to reduce risk. The planner can explain the characteristics of various asset categories to the client, how they perform in different economic environments, and why asset allocation is a rational long-term investment strategy. Through the use of an asset allocation model, the planner can help his or her clients to understand that asset allocation can achieve their goals and objectives with the least risk.

The best asset mix for a particular client will depend on the client's goals, the rate of return required to achieve them, the client's investment constraints (including the amount of risk the client is willing to assume), and the asset categories that have been selected as suitable.

If the asset classes that will be included in the portfolio are not perfectly correlated, the portfolio should be less volatile, and therefore less risky, than a portfolio of assets that move together as conditions change.

With information on the expected return and standard deviation (see exhibit 3-6G) and correlation coefficients (see exhibit 3-6H) between various asset classes, it is possible to compute the expected return and standard deviation of various portfolios. The expected return of a portfolio is simply the weighted average of the expected returns of the asset classes. The standard deviation of a portfolio, however, is affected by the correlation of the returns of the various asset classes in the portfolio.

Basic Series

Serial and Cross Correlations of Historical Yearly Returns

(1926 - 1988)

	Common Stocks	Small Stocks	Long-Term Corporate Bonds	Long-Term Government Bonds	Intermediate Government Bonds	U.S. Treasury Bills	Inflation
Common Stocks	1.00						
Small Stocks	0.82	1.00					
Long-Term Corporate Bonds	0.19	0.08	1.00				
Long-Term Government Bonds	0.11	-0.01	0.93	1.00			
Intermediate Government Bonds	0.03	-0.07	0.89	0.89	1.00		
U.S. Treasury Bills	-0.07	-0.08	0.19	0.22	0.50	1.00	
Inflation	-0.02	0.06	-0.17	-0.17	0.01	0.41	1.00
Serial Correlations	0.01	0.10	0.16	0.09	0.28	0.92	0.64

*The standard error for all estimates is 0.13

Ibbotson Associates

Information about returns, standard deviation, and correlation coefficients over different periods of time are available in books and software packages. For example, Ibbotson Associates in Chicago publishes annual and quarterly statistics on domestic common stocks and small-company stocks, intermediate and long-term bonds, U.S. Treasury bills, and the CPI. Ibbotson also has software with statistics on a broader range of domestic and international securities and on certain other asset categories. This information can be combined with spreadsheet templates to compute the yield and standard deviation for portfolios composed of various asset categories.

Some financial planning software packages develop asset allocation recommendations based on input data about the client, the funding objectives, and risk tolerance. Books, such as The Price Waterhouse Book of Personal Financial Planning by Stanley H. Breitbard and Donna Sammons Carpenter, include asset association models based on specific client profiles.

Investment Allocation

An analysis of a client's current portfolio may include a consideration of whether the portfolio is adequately diversified. The CPA may also want to consider whether, in general, the investments are too risky or too conservative considering the client's situation. Factors that may affect a repositioning of investments include the tax effects of the repositioning and the client's goals and objectives, risk tolerance, thoughts on suitability, financial position, liquidity requirements, income needs, financial responsibilities, and age.

Various charts of recommended investment allocation percentages have been developed. They may vary the allocations depending on age, life cycle position, net worth, other factors, or a combination of factors. One such chart is illustrated below. Any investment allocation chart has to be modified by an individual client's situation, as well as by current and expected economic conditions.

INVESTMENT ALLOCATION PERCENTAGES BASED ON AGE

AGE	LIQUID INVESTMENTS %	INCOME-PRODUCING INVESTMENTS %	GROWTH-ORIENTED INVESTMENTS %
Twenties	10-70*	10-20	10-50
Thirties	10-20	10-20	70-80
Forties	10-15	10-20	70-85
Fifties	10-15	15-25	60-75
Retirement	15-20	40-60	20-40

*The large spread reflects the fact that some people will be saving to buy a home and others will have already bought one or do not intend to buy one.

Some CPAs develop asset allocation recommendations based on published asset allocation models that coincide with their investment philosophy. Such information may be found in quarterly published asset allocation models or models published on a more frequent basis by brokerage houses and investment newsletters. In addition, near the beginning of each quarter, The Wall Street Journal publishes the asset allocation models of several of the large brokerage firms.

The asset classes in a client's portfolio should be accurately defined. If the portfolio will contain small-company stock, data on the S&P 500 is not appropriate information for yield estimates.

A desirable asset mix is one that satisfies the return needed by the client and has the lowest risk. This asset mix, however, should be discussed with the client to determine if the client feels comfortable with it. Its inherent risk should be quantified for the client to see if he or she is satisfied with, for example, a 90-percent probability that his or her education-or retirement-funding goal may be achieved. If the client wants a less risky scenario, additional resources will need to be allocated or the goal modified. Some CPAs limit the riskiness of asset allocations by limiting the amount (perhaps to 40 percent or 50 percent) that can be allocated to any one asset class.

Implementing the Asset Allocation. Implementation begins when the client has an appropriate asset allocation model that meets his or her needs and constraints. Implementation may mean identifying mutual funds that correspond to the asset categories in the allocation, or it may mean working with a broker or money manager to implement the model.

The great variety of mutual funds makes it possible to carry out many asset allocation models by using a portfolio of mutual funds. In determining whether a particular mutual fund will fit into the model, the client or CPA should not rely on the fund description in the prospectus, but should observe the actual portfolio and consider the investment philosophy of the fund's management.

Index funds may be useful in carrying out the asset allocation models of certain clients. A number of asset allocation funds are also available. In addition to stocks, bonds, and cash equivalents, these mutual funds can invest in international securities, real estate securities, and precious metals. If, after considering the client's objectives and constraints, the asset classes and risk are suitable, these funds may provide the diversification that the portfolio requires. Mutual funds provide those investors with small investments with diversification within asset classes or, in the case of asset allocation funds, among asset categories.

If a client's investment portfolio is sufficiently large to permit adequate diversification through holdings in specific securities, the client, with the CPA's assistance, could work with brokers or money managers to select specific securities. The CPA could then review their recommendations for compliance with the client's objectives and the asset allocation model.

Transaction costs and taxes are important considerations in creating implementation strategies. Transaction costs for different types of investment vehicles vary considerably. In a speech given to the 1988 New Orleans Investment Conference, Mary Calhoun, a former broker with Merrill Lynch, indicated that the following are average commission ranges on various investment products:

Investment Type	**Commission Range**
Municipal bond	1 - 2%
Unit investment trust	3 - 4.9%
Mutual fund (load)	4 - 6%
New mutual fund	6 - 8%
Common stock	1 - 3%
New stock offering	3 - 10%
Limited partnership	6 - 10%

High transaction costs or taxes can ruin an otherwise sound investment strategy. Certain strategies can be used in the selection of mutual funds or specific securities that will further reduce the client's investment risk. If dollar cost averaging is used for the investment of cash flow and portfolio repositioning, the client would buy more securities when prices are low and fewer when prices rise.

The layering of fixed-income securities (that is, buying securities with staggered maturities) would protect the client from rolling over large portions of his or her fixed-income securities when interest rates are unfavorable. By timing maturities of fixed-income securities to coincide with funding needs, the client would eliminate interest rate risk on those securities.

Management Tactics. After a portfolio has been positioned to correspond to the asset allocation model, performance can be compared with market indexes to evaluate whether portfolio objectives are being accomplished. Active or passive tactics can be used to manage the portfolio.

Active management implies that the asset allocation will be periodically adjusted to take advantage of market-timing opportunities or changes in economic forecasts.

Some CPAs use passive management, which is a long-term strategy with no attempt to outguess the market. They believe this method is justified because of studies that demonstrate that portfolio return is determined mainly by asset allocation. These CPAs note that, on average, short-term attempts to time market movements are unsuccessful. Market timing can also result in high transaction costs. Their allocation recommendations therefore remain fixed, unless there are changes in the client's goals. The client's liquidity needs change as the time to spend the accumulated funds approaches, or there are changes in the assets themselves (for example, in expected returns or risk). Money managers tend to focus on short-term strategies. An increasing amount of market activity is short-term. By adopting a long-term buy-and-hold strategy, investors can benefit from this trend and take advantage of the steady growth of profitable companies.

Other CPAs acknowledge that economic forecasting and market timing are not viable alternatives. Certain inflation studies, such as those published by Salomon Brothers and Morgan Stanley (see exhibit 3-6I), indicate that financial assets perform best when they are in a low-inflation environment, and hard assets do better when inflation increases. CPAs may attempt to adjust their fixed allocation if they believe there will be a significant change in the inflation trend.

Although CPAs are able to justify using either active or passive portfolio management techniques, most will debate the use of rebalancings. Rebalancing is the procedure used to maintain the desired asset allocation by selling portions of growing positions in order to purchase positions in classes that are experiencing less growth. Recent studies indicate that regular rebalancing of a portfolio has little effect on its performance.

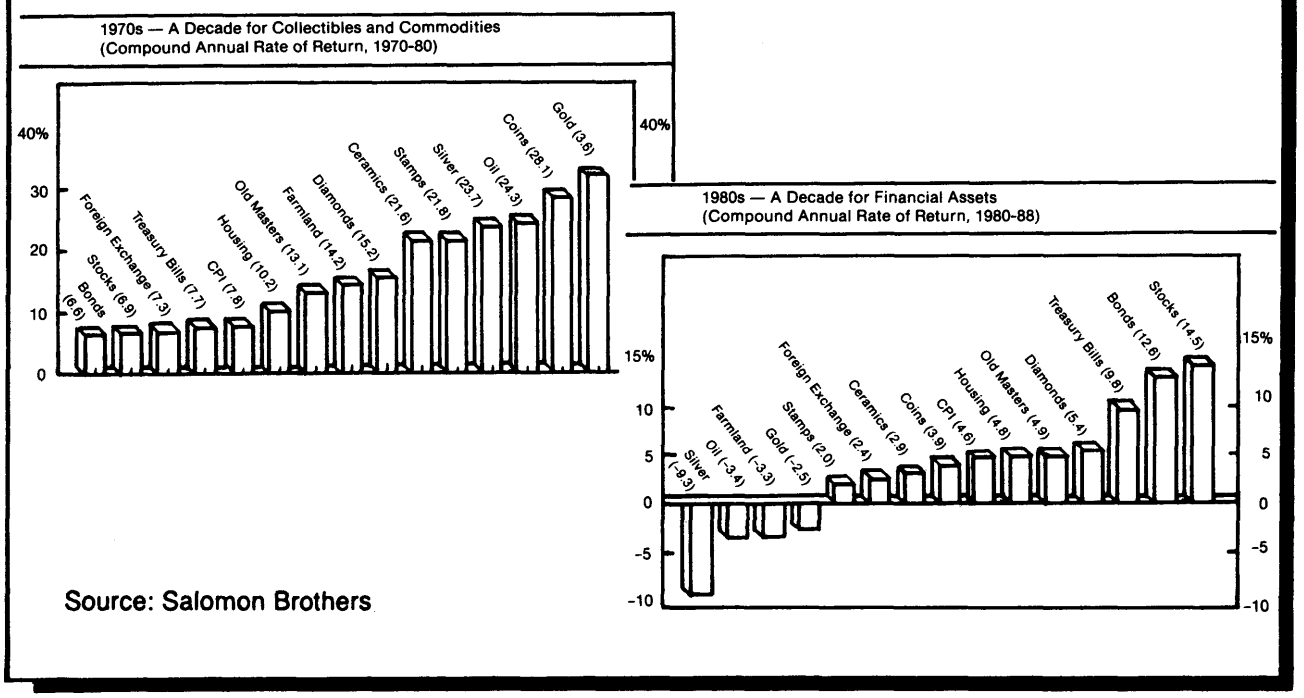
ASSET CLASS RETURNS AND INFLATION

TABLE 1. Annual returns under various economic conditions since 1871

	Deflation (four periods)	*Price stability (four periods)*	*Disinflation (four periods)*	*Rapid inflation (five periods)*
Consumer Price Index	– 3.3%	.1%	1.4%	8.3%
Stocks	– 3.3	20.8	13.8	5.8
Bonds	5.2	4.9	3.8	3.8
T-Bills	4.8	2.7	3.7	8.8
Real estate	– 6.6	4.1	5.8	12.5
Silver	– 13.2	– .3	– 1.3	21.5

Source: Morgan Stanley

ASSET CLASS BEHAVIOR IN RECENT INFLATION PERIODS



Some CPAs believe portfolios should be repositioned at least annually to correspond to the specified asset allocation. Dollar cost averaging can be used to accomplish the repositioning.

Recommending Specific Investments

The investment planning services of some CPAs include recommending specific investments to clients. However, the art of selecting mutual funds and individual securities is complex. The CPA must look at all aspects of the fund or security (which includes a review of the prospectus or annual report), talk to the company's management, and review various fundamental and technical information. Most CPAs leave the selection process to capable brokers, investment advisers, or more managers. Only 10 percent of professional managers outperform the market benchmark, the S&P 500, by over 2 percent in a ten-year period. It is therefore difficult even for a firm with a research department and the necessary analytical investment tools and support to make suitable recommendations. Many CPAs believe their role in the process is to evaluate the recommendations of their clients' advisers to determine if they comply with the clients' financial objectives and investment constraints.

STEP 10--PROVIDING IMPLEMENTATION SERVICES

As indicated on page 3-6.04 there are numerous implementation services that CPAs provide. In developing a personal financial planning practice, each CPA needs to decide the level of services to provide. This decision may be affected by whether the CPA has registered as an investment adviser.

The following implementation services are discussed in detail in this section:

- Selecting investment managers (that is, mutual funds and money managers)
- Selecting securities brokers
- Reviewing the suggestions made by the client's advisers and brokers
- Selecting specific securities

The suggestions that are described on page 3-6.68 for documenting procedures with the planning process apply also to documenting procedures used to provide implementation services.

Selecting Money Managers

The way in which money is invested is critical to the success of an investment plan. Therefore, CPAs often suggest the use of professional investment managers to implement the investment plan.

To help select investment managers, CPAs and their clients could review the services that evaluate and rank money managers (for example, CDA and SEI) and mutual funds, (for example, Mutual Fund Values, BusinessWeek, Money, and Standard and Poor's/Lipper's Mutual Fund Profiles). Readers must be skeptical, however, about the categories used by these services, because a fund may be ranked more favorably if it is not included in the proper category. For example, a growth and income fund may be ranked in a balanced category; it may hold a large cash position due to its bearish predictions. One should therefore review a fund's prospectus, statement of additional information, and the actual portfolio to determine its long-term investment philosophy and policy. (See exhibit 3-6S for a checklist for reviewing mutual funds.)

Following are some of the major factors that should be considered when selecting professional investment managers, regardless of whether they will be mutual funds or money managers. (This list is not intended to be all-inclusive.)

Past Performance. Relative performance should be considered in both up and down markets to obtain an overall impression of the manager's ability. Although greater weight should be given to more recent performance, the CPA should avoid drawing firm conclusions from short-term results that may reflect chance as well as skill. Performance should be evaluated for at least one complete business cycle, which will usually be a period of about six years. It is generally of little value to measure performance too far into the past (that is, more than ten years). All investment institutions evolve in character or change over time as a result of personnel, organizational, and strategy changes. Such out-of-date information has little relevance for future performance.

The critical question is, What are the implications of good past performance for future performance? The link between past and future performance may be weak for the following reasons:

- Changes in personnel and other extraneous effects are liable to cause relative performance to vary continuously over time.

- In the short term, good past performance is often a consequence of the strategy being ideally suited to the investment conditions existing at that time. When different conditions arise, as they invariably do, it is unusual for management to alter strategy appropriately. (An example of this are growth mutual funds, which were the best performers in 1983, close to the bottom in 1984, and at the top again in 1985 and 1987.)

- Good past performance can arise for purely fortuitous reasons, particularly over the short term. Luck inevitably plays a part in investment success because the success was determined by factors that, to a large extent, were initially unknown to the investor.

No individual or institution, even one possessing an abundance of past-performance statistics, has been able to find an adviser who has consistently outperformed rivals. Therefore, the CPA who chooses the most recent top-performing manager does not necessarily ensure success.

Charges. Management fees for money managers are typically based on a percentage of investment assets under management, a percentage of appreciation during the period, or a combination of the two methods. Many banks manage money for .5 - 1 percent of assets under management. Money managers' fees usually range from 1 percent to 3 percent. Another consideration is whether transactions are conducted on a discounted basis for clearing or whether a full retail commission is paid to brokers because the manager expects referrals of additional clients from the brokers.

Mutual funds tend to levy charges apart from the management fees on a variety of bases; some through front-end or back-end loads and others through 12b-1 charges (administrative and marketing costs taken out of each year's profits). It is important to estimate the charges of each mutual fund in future years, since the costs in the first year are unlikely to tell the whole story. This is especially important when load funds are used because a one time front-end load distorts the following year's charges.

The expense ratio is important for the estimation of future charges. In the expense ratio it should be noted whether the mutual fund initiated 12b-1 charges in the past year and whether they have been taken into account.

When considering no-load funds, mutual fund remuneration is generally not an important factor, since marginally superior performance tends to swamp higher relative charges.

Status. Investment advisers gain a high level of confidence from both clients and CPAs through the following:

- A long-established history
- Public reputation and prestige
- Size of assets managed by the adviser or management company
- Growth of assets under management

Investment Team. A factor of good performance is the technical ability of three groups of people: senior strategists and investment directors, the manager, and analysts and other support staff. Money managers should be experienced and well motivated, and hâve their own managers who are both supported from below and monitored from above. Clients or their CPAs should identify the strength and the nature of management companies' house policies as set by the senior directors, as well as the degree of flair and individuality encouraged at the managerial level.

It is difficult to assess the investment expertise of an institution's investment department.

Although biographical profiles give some insight into the depth of experience of an investment team, other marketing materials usually contain little information. Presentations made by the investment team may be helpful, but typically, only the team's marketing representative will be present and often the information he or she offers is limited in scope. In view of this difficulty, it is natural for the CPA or client conducting the due diligence to rely on past-performance records. Thus, the CPA or client--and in particular, the investment manager--should remain in regular contact with the senior members of the investment team to obtain a more objective view of the talents of particular teams.

Investment Decision Process. The right investment talent is only half of the story. To be effective, investment managers require the following:

- An efficient decision-making structure
- Sensible delegation
- Fast implementation of policy
- Close monitoring from above
- Effective teamwork
- Avoidance of self-interest

Risk Profile. The CPA and client try to match up the client with a money manager who shares the client's attitude toward risk. Money managers may be adventurous or timid, but more often they follow an average passive strategy. Furthermore, not all money managers have rigid procedures in place to control risk. Risk strategy is obviously a key concern; thus, efforts to understand the manager's risk profile are necessary if the client is to feel comfortable with the manager.

CPAs should inquire about how the management structure monitors the risk taken by its managers and what controls are in place to prevent managers from taking undue risk. CPAs should also consider the various factors the adviser takes into account to control the risk of each managed fund or account.

Strategy. The money manager's strategy should be consistent with the client's investment objectives. If the client is going to have confidence in the manager, he or she needs to obtain an understanding of the investment strategy.

The following issues will aid CPAs in determining the investment manager's strategy:

- Reasons behind the current asset and sector distribution;
- Methods adopted for selecting securities;
- Decision-making process for strategy changes;
- Means by which strategy changes are implemented; and
- Degree to which the portfolio is actively managed.

Finally, it is worth emphasizing that a successful strategy requires both efficient decision making and decisive implementation.

Flexibility. The client should not make the selection decision with the expectation that the relationship will last forever. Everyone should be given the opportunity to change his or her mind, so exit terms should be carefully reviewed. This is especially true when clients opt to use derivative products. In addition, clients should be flexible in the type of management used. For example, can the client move with ease from commingled funds, (such as mutual funds) to individual managers? Some funds have redemption charges, while others have penalties imposed on them. Therefore, the fee charged for moving out is an important consideration for the client.

Investment Administration. With the use of computers, most institutions managing assets offer an effective administration that eliminates the need for the client to get involved except in a limited sense, such as telephone switching. CPAs should place emphasis on identifying these few institutions that lack good administration. Administrative services may seem excellent, on the surface, however, as was apparent in many institutions in October 1987, this may not actually be the case.

Investment Management Consultants

Investment professionals known as investment management consultants or investment management supervisors may be used by clients to screen money managers. These consultants can be helpful in realistically outlining investment expectations for the client and in finding the right manager to fill those needs. Screeners are often paid with soft dollars (that is, the manager will direct a portion of trades for the investor's account to be run through the screener's firm), hard dollars (that is, a fixed fee), or as a percentage of the dollars being invested. Changing Times produces a geographical listing of various talent scouts in its annual Financial Services Directory.

Problems in Selecting Managers

The following are possible obstacles to the process of selecting managers:

- Managers who lack a track record in a down market are hard to evaluate. A manager who has gained experience only in up markets may not have the ability to preserve capital during a declining market.

- Managers who use speculative strategies in volatile areas may increase the portfolio's risk. This would include areas such as trading in futures contracts, commodities, options other than covered calls, arbitrage, and lettered stock.

Checklist for Selecting An Investment Manager

Exhibit 3-6W, is a checklist that summarizes the factors to consider in selecting investment management for a client.

Factors in Selecting a Securities Broker

The following list includes major factors that several consulting organizations consider when selecting a broker. The list is not meant to be all-inclusive.

- Background. Select a broker with suitable education and experience who keeps abreast of current information and trends. The broker should be trustworthy, inspire confidence, and be willing to educate clients in issues related to investments.

- Reputation. Try to determine the broker's reputation among other professionals. Ask the broker to provide names of clients who will provide references.

- Service. The broker should offer good service and be accessible during critical periods of economic correction. Experience is the best indicator of the quality of a broker's service. Determine how many years of brokerage experience he has and how long he has been with the firm. A change of firms can be disruptive to clients.

- Broker's Recommendation of a Manager. If a stockbroker is recommending a manager, it is important to evaluate how the broker is paid and how large is the universe of managers from which he or she is selecting.

- Using a retail brokerage firm's own manager. This may increase administrative fees and limit the accountability of managers who invest by following their own philosophy.

- Discount rate requirement. If the manager does not require that trades be conducted at a discounted rate, the investor may be paying an excessive amount for trading costs.

- Degree of speculation. If a portfolio has a high rate of turnover, the manager may have an underlying philosophy of looking for a speculative quick profit, rather than long-term growth and income.

- Balanced vs. equity account. There can be a significant variance in account performance for a balanced account containing both equity and fixed-income components compared with a strictly equity account.

- Rapid growth of manager. Rapid growth of the manager and diversification into ancillary areas may affect the manager's investment strategy and results. Managing $50 million, while fundamentally similar, can differ from managing $500 million. A successful manager may also expand into other areas, such as pension administration, which may affect the manager's proven ability to successfully manage money.

- Research. The research material provided by the broker should be easy to understand, informative, and educational.

- Investment analysts. The brokerage house should have a good team of investment analysts that is well-regarded by the investment community. Securities recommendations should come from the analysts.

- Internal advice. Ask the broker the usual source of buy and sell recommendations. Some brokers do not follow the internal advice they receive from their support staff or research teams. They feel that they have done better due diligence than their research teams. This may result in poor performance. Brokers must have the discipline to follow their firm's advice.

- Investment policy. The broker should either follow the investment policy statement developed for the client by an investment adviser or develop one for the client. All products bought by the broker should be outlined in the statement.

- Work with CPAs. Has the broker ever worked with a client's CPA? What CPAs has he or she worked with? Would the broker be willing to work with a client's CPA?

- Asset allocation. Is the broker familiar with the asset allocation concept? Is the broker willing to develop an asset allocation model for the client and review it with the client and the client's CPA?

- Portfolio turnover. Ask the broker about how he or she arrives at sell recommendations. Inquire about the average annual portfolio turnover of client accounts.

- Products. The brokerage house should be able to offer the client a wide array of suitable investment products.

- Fees. All fees should be disclosed to the client, including commissions, management fees, service fees, front-end loads, and redemption fees. The broker should receive reasonable but not excessive compensation.

- Administration. Monthly brokerage statements, especially municipal bonds, should be clear, understandable, and accurately priced.

- Support staff. The support staff should be efficient and timely in providing answers to problems.

- Settlement of disputes. Some brokerage firms insist on using arbitration rather than the courts to resolve disputes. This is often provided for in the firm's written agreement with the client.

Monitoring. Determine if the brokerage firm effectively monitors the activities of its brokers. Close monitoring by top management prevents the broker from taking undue risk with clients' portfolios.

Reviewing Suggestions of a Broker

Why Would a CPA Review the Suggestions of a Broker? The implementation of an investment plan as a segmented service or as part of a comprehensive financial plan is usually a critical procedure that can have a significant impact on the future success of the plan. The role of the CPA in reviewing recommendations made by a securities broker may be to determine whether the proposal will comply with the client's desire and capacity to take a financial risk. (See page 3-6.08 for discussion of risk tolerance.) Such a determination by the CPA is based on sufficient knowledge of the client and the investment strategies being considered in the proposal.

The CPA may also assist in the development of overall investment policies and strategies. These policies and strategies include allocating the investments by percentage between various asset classes, determining the allocation of assets into tax-exempt or tax-deferred products, determining the policy and procedures for reinvesting income from the portfolio, establishing an investment selection process that includes investment criteria and purchase and sale approvals, hedging tactics, portfolio monitoring, and providing evaluation procedures and other controls.

When Would the CPA Review the Suggestions of a Broker? Brokers make suggestions and recommendations under varying situations, such as an occasional tip about a "hot" security for a short-term profit, a new acquisition to an existing security portfolio, an exciting new product or concept to add diversity to a portfolio, and a periodic repositioning of the portfolio to comply with a predetermined investment strategy or policy. Brokers also make recommendations during the establishment of a completely new portfolio from existing investments or from uninvested funds (new money).

Only under specific conditions may a CPA wish to become involved in, and render assistance on, a broker's recommendation. The materiality of the recommendation is probably the key to the level of the CPA's involvement. If the recommendation or suggestion has a material impact on the client's portfolio or financial goals, the intervention and assistance by the CPA would appear appropriate. Material transactions include implementation of a new portfolio, major repositioning, and product acquisitions representing 10 percent or more of the entire portfolio. The CPA may choose to avoid becoming involved in small trades or transactions for general portfolio maintenance, since these are usually of low impact.

How Would the CPA Review the Suggestions of a Broker? A periodic portfolio review and evaluation consists of revisiting a broker's past suggestions and recommendations to determine continued compliance with objectives and investment policies. An appropriate approach to such a review would be a composite analysis of each asset class showing a weighted time and value performance of the securities as a whole, along with composite weighted risk factors of the asset class. The composite data might include annualized appreciation and yield, the price earnings ratio, the relative price earnings ratio, the beta factor, the financial strength rating, the average cost per share, the average fair market value per share, the average industry rating, the average forecast performance rating, the average dividend yield, the average age of the asset class, and identifying securities that occupy a significant position in the asset class. In some asset classes (such as real estate) it may be more relevant to compare actual performance with forecasted performance -- analyzing the material variances to determine any change in risk factors.

Current suggestions and recommendations are evaluated in a similar manner. The CPA's role is to determine overall compliance of the portfolio with the client's stated objectives and not necessarily to review each security selected by the broker. Small investments in risky asset classes may not justify the CPA's attention.

What Should the CPA Do After Evaluating the Suggestions of a Broker? If it appears that the broker's suggestions and recommendations comply with the client's objectives and also with the client's desire and capacity for financial risk, the CPA may want to communicate that information to both the client and the broker. If the broker's proposals do not comply, the CPA should inform the client and, at the client's request, the broker. To illustrate, a client may have an unrealistic goal, and, to have any chance in accomplishing the goal, must incur great financial risks. These risks may exceed the client's capacity or desire for risk, even though the proposal may be a suitable means of achieving the client's unrealistic goal. The CPA may want to document in writing to the client, and possibly to the broker, the reasons why the proposal seems inadvisable. The CPA may want to withdraw from the financial planning engagement if the client insists on pursuing the inappropriate proposal. In these circumstances, the CPA may wish to consult with his or her legal counsel.

STEP 11 -- MONITORING INVESTMENT PERFORMANCE

The CPA and his or her client may agree to include monitoring services as part of the engagement process. Monitoring is the process of tracking the investment performance of the client's portfolio, comparing it with indexes of market performance, such as the S&P 500, and then comparing it with the assumptions used in developing the client's plan.

Not all CPAs offer structured monitoring services to personal financial planning clients. Some CPAs informally determine investment performance during periodic planning updates as part of their ongoing personal financial planning services.

The first step of this determination is to calculate the investment performance of the various investment vehicles in the client's portfolio for the period being evaluated. Actual performance is compared with expected performance to determine the extent to which the results are over or under the plan projections and what effect the results have on the client's objectives and goals.

The CPA needs to determine how to measure the performance of each investment vehicle or class. Investment returns include interest, dividends, rental income, royalties, and realized and unrealized capital gains and losses. Performance for investments that primarily generate periodic income, such as interest or dividends, are generally easier to measure than investments such as limited partnership interests and real estate, which are being held for capital gains or long-term appreciation.

Performance Measurements

The current yield, the nominal yield, and the yield to maturity are three performance measurements the CPA can use when evaluating investment performance. All three work well for evaluating the amount of regular income received from stocks and bonds.

Current yield = Annual investment income ÷ Investment's current price or value

The current yield is normally used to evaluate common and preferred stocks and can be used for bonds as well. In general, it is more meaningful to a client than the nominal yield, since it expresses performance relative to the investment's current price.

Nominal yield = Annual interest or dividends ÷ Investment's par or face value

The nominal yield is also called the dividend rate when referring to preferred stocks with a par value, or coupon rate when referring to bonds. Yield to maturity (YTM) is a measurement tool that works well for evaluating bonds or comparable fixed-income investments. This measure of yield is also called true yield, net yield, or effective yield.

Bonds selling at a premium:

$$\text{Yield to Maturity (YTM)} = \frac{C - P/Y}{(MP + PV)/2}$$

Bonds selling at a discount:

$$\text{YTM} = \frac{C + D/Y}{(MP + PV)/2}$$

C is the yearly coupon payment.
P is the bond's premium above par.
D is the bond's discount from par.
Y is years to maturity.
MP is market price
PV is bond's par value.

Internal Rate of Return (IRR)

Some CPAs have found the IRR helpful when computing return on investments that make significant periodic distributions. The IRR is defined as (1) the discount rate that makes the net present value of all cash flows equal to zero, (2) the interest rate that makes the present value of the cash inflows equal to the initial cash outflows, or (3) the maximum rate of interest that could be paid to a financial institution for borrowing the money invested over the life of the project and could exactly break even. Consider the following example:

Original investment	$3,791
Useful life	5 years
Annual cash inflow from operations	$1,000
Internal rate of return	10%

DISCOUNTING EACH YEAR'S CASH INFLOW SEPARATELY

		PRESENT VALUE OF $1, DISCOUNTED AT 10%	*PRESENT VALUE OF $1,000*
Cash Flows:			
Annual cash savings	Year 1	.909	$909
	Year 2	.826	826
	Year 3	.751	751
	Year 4	.683	683
	Year 5	.621	621
Present value of future inflows		$3,791	
Initial Outlay $1,000		(3,791)	
		- 0 -	

Net present value
(the zero difference proves
that the rate of return is 10%)

Assumptions. The following are assumptions made on the IRR:

1. Tax savings are treated as cash inflows.
2. Tax savings are received on a quarterly basis.
3. Each cash inflow (including tax savings) represents a partial return of capital.
4. The investor will reinvest the capital recovered.

5. The investor will achieve and maintain a marginal tax rate as stated in the offering, and the tax bracket will not decrease as a result of the investment.
6. There will be alternative minimum tax assessed as a result of the investment.
7. All deductions included in the projection will be allowed by the IRS.
8. Income resulting from taxable income from operations (phantom income) is treated as a reduction of yields.

Other Performance Measures

Many portfolios contain assets held for capital gain or appreciation potential. Although the performance or rates of return from these assets are often difficult to obtain, they are essential for measuring performance. The performance is measured over the assets' holding period. By using the beginning and ending values and the number of years the investment has been held, the CPA can calculate the investment's annual compound rate of gain, as shown in the following example:

Current value (present value)	= $20,000
Beginning value	= 5,000
Number of years held	= 10
Annual (compound) rate of growth	= 14.86%

If the investment also generated income, the current yield would be added to the foregoing calculation to determine the total annual investment return for the asset.

All performance measures should be converted to an after-tax yield to show the effect of income taxes on investment performance. This can be more complicated than might first appear since appreciation (that is, unrealized capital gains) used in the measurement process will not yet have been taxed. The after-tax yield is generally expressed as the current yield multiplied by 1 minus the marginal tax rate.

Performance measures for many investments held by the client will be readily available from published sources, such as The Wall Street Journal, or from the investment managers of the investment, such as mutual funds. The effect that actual performance for a given period has on the client's plan when compared with expected performance or when used to make new projections needs to be quantified and communicated to the client.

The next step in the monitoring process is to compare the performance for the client's particular investment classes with some universal measure to determine how the client's portfolio performed in relation to others. For example, stocks can be compared with composite returns, such as the S&P 500, and bonds can be compared with various indexes, such as the Shearson Lehman government/corporate bond index. Mutual fund performance can be evaluated by various services so that the client's funds can be compared with the universe of mutual funds.

If the client's portfolio, or a segment of the portfolio, is being managed by a professional money manager, the CPA can assist the client in evaluating the manager's performance in relation to the objectives established with the manager. To assist in the performance evaluation, the CPA should read and understand the terms of the management agreement and, in particular, the investment objectives.

The manager's performance is evaluated in relation to the stated objective. For equity investments, the objective might be to outperform the S&P 500 over a three to five year market cycle or to provide a rate of return 3 to 4 percent above inflation over a five year period. The manager's performance also should be compared with that of other managers with similar or compatible investment objectives.

In summary, the monitoring process includes the following:

1. Determine or calculate investment performance for the client's invested assets.
2. Compare actual performance to expected performance and determine the financial effect on the plan.
3. Compare the investment performance of the client's assets to a market index or ranking.
4. Evaluate the performance of money managers in relation to their objectives and their competitors.
5. Analyze the results and make recommendations to the client.

STEP 12--ONGOING ASSISTANCE

Personal financial planning is a process not a plan document, so in a sense, all advice is ongoing. For the CPA, however, ongoing refers to the planning process that follows the initial planning and implementation. Ongoing assistance is the periodic review of the client's financial situation and the periodic updating of recommendations.

Client Expectations

Establishing appropriate client expectations is critical. Appropriate client expectations are probably even more critical to a satisfactory client relationship in the period when ongoing services are provided than in the initial phases of a planning engagement. CPAs want to be extremely clear about what they will be doing for the client, when it will be done, with whom, and why.

Ongoing Services Not Mandatory

Although ongoing services are not a mandatory part of an engagement, it is generally in both the client's and the CPA's best interests to include such services. Most CPAs offer

both one time and ongoing services, leaving it to the client's judgment to choose. CPAs, however, should caution clients if they choose not to elect ongoing services. Such cautionary language should be stated either in the engagement letter or as a preface to the initial planning document and might read as follows:

> The advice contained in this report [or engagement] is based on your present financial situation. The appropriateness of the advice may change as your personal and financial circumstances change or as the economic environment changes. You should, therefore, consider having us continuously or periodically review your financial situation and advise you on how to update your strategies to take such changes into account.

Ongoing services are in the client's best interest because financial circumstances are dynamic. Practitioners may find it personally satisfying to provide clients with ongoing services. The ability to assist and watch clients achieve set goals can be very appealing to many CPAs.

Changes in External and Internal Factors

Changes in factors affecting the client may occur, and the financial consequences resulting from these changes should be periodically assessed. These changes may include factors external to the client (such as interest rates, stock prices, currency exchange rates, tax laws and other legislation, inflation or expectations of inflation, GNP, and other economic indicators). The internal factors that can also change include marital status, income, expenses, net worth, goals, employment, and many more. If the changes in these factors become known, they may affect the client profile, risk exposure, asset valuations, or the attractiveness of debt. Adjustments for the factors should then be made to the client's investment strategies.

Typical Ongoing Services

The following are some of the ongoing engagement services that are not directly related to investments:

- Updated financial statements
- Updated capital sufficiency analyses
- Income tax projections, estimated payments, and compliance with tax-authority inquiries
- Review of existing insurance coverage due to changes in capital sufficiency, company benefits, or changes in market values, and determination of new coverage

- Estate planning changes resulting from changes in intentions, family circumstances, civil laws, tax laws, or the level of wealth or income

- Assessment of changes in company benefits or analysis in connection with utilization of company benefits

The following are some of the services that may be provided in an ongoing engagement and that are related to investments:

- Reevaluation of investable assets based on changes in client intentions, additions from cash flow, changes in statutes, inheritances, gifts received or given, appreciation or depreciation in asset values, and progress in meeting goals

- Revision of asset allocation among categories and subcategories due to changes in the composition of investable assets; the client's investor profile or client's financial exposure; or expectations of economic, market, or company performance

- Assistance with selection of mutual funds, money manager search consultants, money managers, or hard-asset vehicles

- Evaluation of the performance of brokers, money managers, general partners, or a directly invested portfolio

- Assessment of the appropriateness of new vehicles not considered in earlier planning

- Reassessment of the appropriate level and form of liabilities

Methods of Delivering Ongoing Services

Ongoing services can be delivered in a variety of ways. Assessment by the CPA and client of the urgency and exposure to change of the client's financial situation should dictate the nature and frequency of ongoing contact. The greater the changes and sense or urgency, the greater the need for frequent personal contact. CPAs should be pro-active in serving clients, and such contact can ensure the clients' attention and focus when required.

The timing of updates is determined by the engagement agreement. Often, quarterly contact is appropriate. Most clients require at least an annual updating of their financial information and analysis. With less frequent contact, CPAs run the risk of not being sufficiently aware of client circumstances to provide valuable and timely services.

Many times, immediately following the CPA's presentation of the initial analysis, the frequency of client contact is high because of the client's sense of urgency to implement recommendations. Although the frequency of client contact may naturally decline once these initial recommendations are implemented, additional items that are identified may need to be brought to the client's attention.

Documenting the Scope and Content of Ongoing Services

CPAs should document the scope and content of ongoing services in the initial engagement letter. Because of the sensitive nature of the matters on which the client is being advised, all communications should be put in writing. This procedure is also essential for documenting events or commitments that might be forgotten over the lengthy time period the services cover.

Efficient Delivery of Ongoing Services

How can CPAs deliver ongoing services efficiently? Due to the broadly defined nature of ongoing services, paraprofessionals are sometimes well suited to rendering portions of the services. Data collection and analysis often follows a format that is established in the initial planning documents.

Because there are established plans to follow, the CPA can provide more highly centralized services. For example, the CPA may be able to contact all covered executives through periodic communications with the human resource personnel of the corporation that sponsors the financial counseling. Since ongoing services entail contact with the client's other advisers, the CPA should maintain a directory of these advisers by name, function, telephone number, and address.

Purpose of Ongoing Services

The ultimate service the CPA provides is peace of mind. Even when there is not a full slate of technical issues, the CPA should not hesitate to meet with the client. Even if the CPA's review does not identify any burning issues to be addressed, it may either reassure, or simply serve as a confirmation for, a client. The contact with the client may help to further the relationship of trust and confidence that is so critical to successful client engagements.

STEP 13--DOCUMENTING THE PROCEDURES

The CPA documents the investment planning procedures, the client's decisions and the CPA's continuing responsibilities. Documentation is required in supporting the CPA's conclusions and recommendations during any financial planning engagement. It demonstrates how the CPA performed the investment planning process and how the CPA arrived at his or her advice and recommendations. Documentation serves as a future reference to the CPA, provides information to assist the CPA in planning the engagement, and may reduce the possibility of future liability claims against the CPA. Detailed files may be the best defense against a plaintiff's attorney. The retention of adequate files can help expedite settlement of a case.

If outside specialists are needed, the CPA should carefully document the responsibilities assigned to the specialist, any conclusions reached by the specialist, and any decisions made by the client. This is a necessary step whenever the CPA does not perform the entire engagement or have direct control over a particular segment of an engagement.

Documentation is gathered in a variety of ways including the use of data gathering forms, checklists, computer reports, and questionnaires. It may also include notes documenting discussions with the client and reviews of financial statements or other important documents. Most CPAs document their responsibilities for the implementation and monitoring stages. For example, a clear understanding of the services to be performed ordinarily is established with the client by use of an engagement letter. An engagement letter may help prevent potential misunderstandings that can arise with a client.

GOALS FUNDING APPROACH

Many personal financial goals require the accumulation of funds for future use. This is accomplished through savings or by investing assets so that they appreciate or produce income. Whether the particular goal is funding a child's education, providing for retirement, purchasing a home, or maintaining current purchasing power, the approach remains the same. Assets are gathered and put to work to earn the returns needed to reach the objectives in the designated time frame.

The role of the CPA in advising clients on goals funding includes the following investment strategies:

- Quantifying assets available for investment
- Quantifying the rates of return needed to achieve financial objectives
- Identifying characteristics of investment assets that meet the client's investment constraints

(The discussion of investor constraints begins on page 3-6.14)

The CPAs' tools in this process include expertise in dealing with financial assumptions and an in-depth knowledge of clients' current financial resources, financial goals, and investment constraints.

CPAs carry out the following steps in accomplishing the goals funding process:

STEP 1. IDENTIFY SPECIFIC OBJECTIVES. Appropriate investment choices become clear only after the CPA and client identify the client's investment objectives. The selection of specific objectives is therefore the first step clients need to take in developing their goals-funding plan. Vaguely defined goals such as family protection, early retirement, or financial independence do not provide enough information about clients' requirements. CPAs encourage clients to be specific about quantifiable objectives, such as having $40,000 for a down payment on a home in five years.

STEP 2. ASSIGN PRIORITIES AND TIME FRAME. After identifying specific objectives, clients need to arrange their objectives in order of importance. Most people will not have the resources to fund all their goals at any one time. It is important to distinguish the high-priority goals, such as retirement or funding a college education, from goals that are less significant, such as buying a second home or taking a vacation.

Clients also need to determine a time frame for achieving their objectives. The time frame for certain goals, such as funding for college, is determined by external factors. Clients need to establish a reasonable target date or ranges of dates for other goals. When matched with clients' investment constraints, the projected timing may be inconsistent with the degree of risk clients can comfortably accept, and one or more time frames may need adjustment.

STEP 3. DETERMINE AMOUNT OF INVESTMENT ASSETS AND CASH FLOW AVAILABLE TO MEET OBJECTIVES. A critical element in the goals funding process is the determination of current investment assets and the amount clients can save on a regular basis for investment purposes. Consequently, an early step in the process is an analysis of current cash flow. (See pages 3-6.06 for a discussion of identifying investment assets and pages 3-2.01 through 3-2.43 for a discussion of financial statement analysis. See the discussion of cash flow planning on pages 3-3.01 through 3-3.21.)

If current levels of savings are nonexistent or insufficient, the goals-funding process will be slowed until cash flows can be realigned to provide the necessary funds. CPAs use the goals-funding process to illustrate to clients that failure to save, or failure to save enough, will prevent them from achieving their goals within the desired time frame.

STEP 4. CONFIRM THE ADEQUACY OF EMERGENCY RESERVE AND INSURANCE. Before advising clients to allocate savings toward goals-funding objectives, CPAs usually determine whether their clients have sufficient liquidity available for emergencies, as well as adequate insurance coverage. The cost of providing for such noninvestment strategies is deducted from available cash flow to determine the amount available to fund goals.

STEP 5. SELECT FINANCIAL ASSUMPTIONS. To calculate the amount needed at a future date, two financial assumptions must be made: the inflation rate to determine the estimated future cost, and the after-tax rate of return that invested funds will earn.

The procedure for selecting financial assumptions that begins on page 3-6.30 explains a method of estimating investment return. The estimated return is based on the inflation rate assumed by the client plus a premium equal to the historical average returns of various investment classes less the historical average inflation rate. By assuming that the investment return will simply be a stated percentage greater than inflation makes the inflation assumption less critical in funding goals. The investment return selected--low risk, medium risk, or high risk--will depend on the client's risk tolerance and other investment constraints on the goal's funding.

STEP 6. EVALUATE CLIENT INVESTMENT CONSTRAINTS. A client's investment constraints affect the amount of risk and the types of investments that he or she will be comfortable with. Through discussions with the client, and possibly the use of questionnaires or checklists, a CPA obtains the information needed to identify the client's investment constraints. (See the discussion of investment constraints that begins on page 3-6.14.)

STEP 7. MAKE FUNDING CALCULATIONS. A goals-funding calculation is a present value computation that can be made using financial tables or, preferably, a financial calculator. At this stage in the process, the CPA has all the information needed to make the calculation for each of the client's goals: the future amount required, the time frame, the savings and cash flow available for investment, the financial assumptions, and the client's risk tolerance. (See exhibits 3-6X.1 and 3-6X.2 and the discussion of adequacy of resources on page 3-6.29.)

Goals can be funded separately, with investments earmarked for specific goals. Alternatively, certain investments may be earmarked to fund several goals, or the client's portfolio may be considered as a unit for funding all the client's goals.

The CPA can review a summary worksheet (such as the one presented in exhibit 3-6X.2) and the client's current portfolio to evaluate whether the client's overall investment portfolio will be adequately diversified (see the discussion of diversification on page 3-6.20).

STEP 8. FOLLOW-UP AND MONITORING. The planning process does not end when plans are delivered to clients. CPAs continue to track their clients' progress in carrying out plan recommendations. CPAs often contact clients periodically to update their plans, discuss problems that may have developed, offer encouragement, and if necessary, provide assistance in carrying out the plan.

CPAs' services may also include monitoring the results of the actions taken by clients. The results are compared with the assumptions used to develop the plan. Depending on the services CPAs provide and their arrangements with their clients, they may monitor informally through discussions with the client or they may actually track the investment performance for their clients. Although some CPAs monitor results quarterly, many others believe annual monitoring is advisable in most situations. (See the detailed discussions of monitoring and ongoing services on pages 3-6.61 and 3-6.65 in this module.)

STEP 9. ADJUSTMENT AND REVISION. The monitoring of a client's progress may indicate to the CPA that the investments are not earning the assumed yield, taxes have increased, or other problems have developed with the original funding assumptions. Plans need periodic adjustment so that clients will be able to accomplish their objectives.

CPAs frequently recommend that clients' plans be reviewed every one to three years. This is an opportunity for clients to reconsider their goals, the plan assumptions, and the estimated amount required to fund the goals. Based on the revised information, CPAs can revise recommendations and strategies as necessary.

THE GOALS FUNDING PROCESS

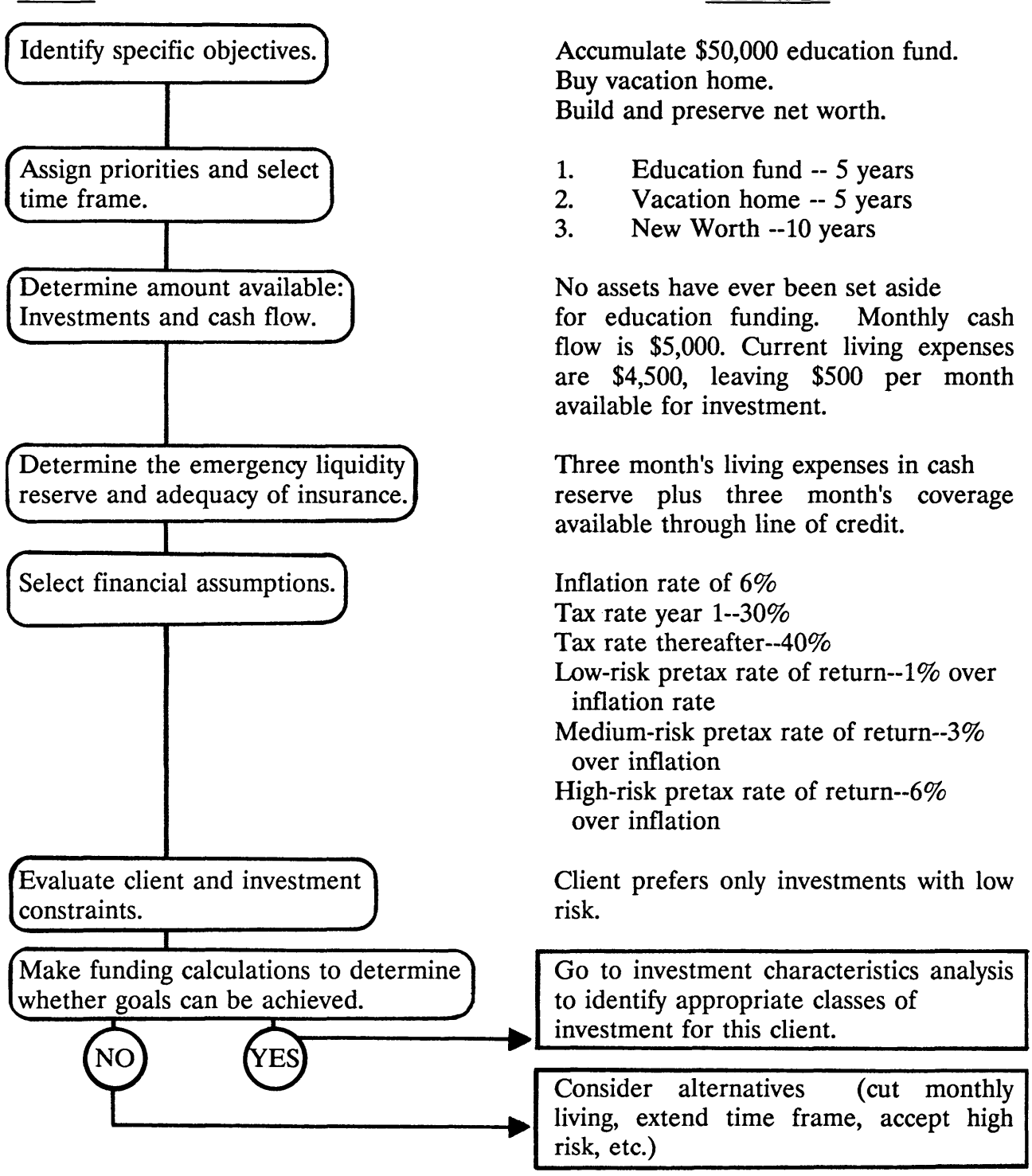
In some engagements, it may not be possible to progress smoothly from one step of the goals-funding process to another. Information obtained in one step, such as "cash flow available for investment," may require that an earlier step be modified, such as "assign priorities and select time frame."

CONSERVING FINANCIAL RESOURCES AND GOALS FUNDING

The conservation of financial resources requires the protection of the financial resources accumulated by clients to avoid depletion due to economic factors, such as inflation, and strategic errors, such as the assumption of too much investment risk. It is primarily a process of managing risk and return. In a broad sense, however, the goals-funding approach can be helpful. The goal in this instance is to achieve an overall after-tax return in excess of the inflation rate. The amount of the excess is determined by the amount of risk the client is willing to assume.

Exhibit 3-6J summarizes the goals funding approach.

THE GOALS FUNDING PROCESS



OTHER SEGMENTED PLANNING ENGAGEMENTS--INVESTMENT PLANNING CONSIDERATIONS

CPAs are often engaged to do segmented planning in areas other than investment planning. The engagements may, however, have investment planning implications. The final report should reflect in general terms how the engagement recommendations affect the client's investment plan. If the implications are significant, the CPA considers them in developing plan recommendations.

For example, a cash flow planning engagement may indicate a need for investments that generate more cash flow. Alternatively, if the analysis indicates that the client does not need current cash flow, the CPA may recommend that investments concentrate on growth and appreciation. Cash flow planning engagements often require a review of the client's investment planning.

Financial statement analysis may also indicate a need for investment planning, such as a need to diversify investments or to reduce risk.

The following income tax issues may affect investment planning:

1. The deferral or tax-exempt characteristics of investment vehicles
2. The status of passive activity gains and losses
3. The client's investment interest expense situation
4. The status of capital gains and losses
5. The tax basis of investments
6. Alternative minimum tax considerations

Risk management decisions, such as whether to self-insure, may affect the client's investment planning. Examples of estate planning issues that may involve investment planning include the need for liquidity and the amount of management skill required for investments that will pass to heirs.

In accepting segmented engagements, the planner should exercise caution, since it is difficult to separate investment planning from other essential areas of planning. The distinction among these planning areas is not definite, and often the engagement would necessarily include some or all of these areas, as well as others. Accordingly, the CPA may decide to clearly define the scope of the engagement in his engagement letter. At the same time, the CPA should consider the implications of the investment planning engagement as they impact on other related areas and should determine whether he or she should include these others areas as part of the engagement. Understanding the client's personal financial planning objectives is, of course, essential.

It is sometimes more appropriate to perform segmented planning in the investment planning area if the CPA has performed comprehensive personal financial planning

earlier. In this case the CPA would have the requisite knowledge to make an informed judgment as to how the current investment planning engagement would impact other areas, and the CPA would include those areas as part of the current engagement.

CONSULTATIONS INVOLVING INVESTMENT PLANNING

When rendering consulting services on investment planning, the CPA should give due consideration to all of the other areas that comprise personal financial planning. Most CPAs who feel they can exercise due professional care will render general consultation of an educational nature in investment planning. Usually, no specific recommendations are made when the CPA does investment consultation in that he or she has not taken the necessary steps to review the other financial planning implications of any specific recommendation. For example, if a client should ask about the investment in tax-exempt bonds, the CPA cannot specifically answer this question without doing tax planning. To respond to this specific question, the CPA should preferably have an overall understanding of the client's financial plan. On a consultation engagement, however, the same CPA might consider explaining to the client what role tax-exempt bonds normally play and under what circumstances they can be used successfully in carrying out investment and personal financial planning objectives.

THE CPA ACTING AS A PURCHASER REPRESENTATIVE

Some clients ask their CPAs to serve as a purchasers representative in connection with the client's acquisition of a limited partnership or other investment. Normally, the information given in a questionnaire completed by a purchaser representative is used in determining whether he or she meets the requirements of the Security and Exchange Commission (SEC). In completing this questionnaire, the CPA affirmatively represents that, in financial and business matters, he or she has knowledge and experience that render him or her capable of evaluating the merits and risks of the investment contemplated by the offering memorandum.

Although it is unclear whether the CPA must be a registered investment adviser in order to be a purchaser representative, the CPA must nevertheless exercise due diligence, as well as comply with existing CPA standards. In addition, it is unclear whether the CPA's liability insurance will cover his or her acting as a purchaser representative. Because of this highly uncertain situation, a CPA rarely assumes this responsibility on behalf of a client.

ADDITIONAL INVESTMENT ANALYSIS WORKPAPERS

Exhibits 3-6R, 3-6S, and 3-6T are optional work sheets designed to assist CPAs in the evaluation of mutual funds that a client may be considering. Exhibits 3-6R nd 3-6S are used together to compare the fees charged by various funds. CPAs should note that prospective information is used in columns (4) and (5) of exhibit 3-6R. Column (4) is an

assumption about a fund's average annual return over the number of years in column (2). Column (5) is a projection based on the amount of current fees.

Exhibits 3-6U and 3-6V are optional work sheets for evaluating insurance products to be used as investments. A policy's projected credited interest rate before surrender charges can be determined on exhibit 3-6V. The credited interest rate represents the interest paid on the beginning balance of the accumulated value account before applying premiums received and annual policy costs.

A policy's internal rate of return is its return on invested dollars net of annual mortality costs (the cost of insurance) and management charges. That rate can be computed on a financial calculator. The annual payment is the same as the annual premium an the future value is the accumulated value at the end of a specified period of years. Because that calculation ignores the policy costs, it may be preferable to reduce the annual premium by the lowest term premium that is available to the client.

The calculations of the credited interest rate before surrender charges and the internal rate of return rely on information from the insurer about the cost of insurance, future dividends, and accumulated values. Those amounts may not be guaranteed by the insurer. Some companies may be conservative about estimating the amounts and others may be more aggressive. The reliability of the calculated rates depends on the quality of the information from the insurer.

INVESTMENT PRODUCTS

The following is a list of certain commonly encountered investment products. It is not meant to be all-inclusive. In addition, new products are constantly being developed.

COMMON STOCKS

Publicly held common stocks are highly marketable securities that have had an average annual return of 9.8 percent over the sixty-year period ending in 1985, twice the average annual return of long-term corporate bonds. Stocks are riskier than fixed-income securities because of the greater variability in their annual yield, which may be negative in some years. Risk can be quantified in terms of standard deviation, a measurement based on differences between the actual yield each period and the mean yield. The standard deviation of common stocks during the sixty-year period ending in 1985 was over two and one-half times that of long-term corporate bonds. Stocks are rated for their quality, security, and potential growth by rating services such as Standard & Poor's Corporation, Moody's Investors Service, and the Value Line Investment Survey.

Growth Stocks

Growth stocks are generally stocks of corporations with increasing profits that reinvest a large percentage of their earnings to achieve continued expansion. The value of growth stocks is expected to increase more than the market average.

Income Stocks

Stocks that pay relatively high dividends, such as utility stocks, are called income stocks.

PREFERRED STOCKS

Preferred stockholders have preference over common stockholders in liquidation, but their claims are subordinate to those of general creditors and bondholders. Dividends are not guaranteed but they may be cumulative, in which case preferred stock dividend arrearage is paid before any common stock dividends are paid. Holders of noncumulative preferred stock receive dividends only if they are earned.

Some preferred stock is callable, usually at a premium. A call feature is a disadvantage to preferred stockholders because the corporation will only call the stock if its dividend rate is higher than current interest rates. If the stock is called in, the investor may have to reinvest the funds in a security yielding a lower return.

BONDS

Bonds provide a fixed income and, if held to maturity, relative safety of principal. They are subject to interest rate risk if not held to maturity. They are also subject to purchasing power risk because their yield may not be equal to the average inflation rate during an investor's holding period. If the financial condition of the issuer declines, the bonds' rating and price will fall. A sufficiently serious financial problem could cause default and loss of principal. Bonds sometimes have call provisions that permit the issuer to require the holder to redeem the bonds at a specified amount before maturity. As noted earlier in the discussion of preferred stock, a call feature is an advantage to the issuer and a disadvantage to the holder, causing a callable bond to be issued with a somewhat higher interest rate. The bonds are usually callable at a premium above face.

Corporate Bonds

Bonds issued by corporations may be unsecured, secured by assets such as corporate real estate or mortgage bonds, or subordinated debentures (subordinate to all general creditors). The stated interest rates of bonds reflect, among other things, their security interest

in the corporation -- the better the security, the lower the interest rate.

Short-term corporate bonds mature within five years. Medium-term bonds usually mature in five to ten years and are frequently secured by equipment, real estate, or other property. Long-term bonds mature in ten to twenty years or more and are generally used by corporations having equipment with long useful lives, such as utilities.

Municipal Bonds

Interest on the obligations of states, the District of Columbia, U.S. possessions, and their political subdivisions is generally exempt from federal income tax. Most, but not all, states exempt from state income tax the interest from obligations they issue and from obligations issued by U.S. possessions. Capital gains and losses from the sale of municipals, however, are subject to federal income tax and generally to state income tax. Some states do not tax capital gains derived from municipals they issue.

Certain municipal bonds are considered "private activity" obligations if more than specified percentages of the bonds' proceeds provide financing for activities that are not general governmental operations or government-owned and -operated facilities. IRC sections 141 to 147 provide rules and effective dates for municipalities to use to determine whether the interest paid on private activity bonds is tax-exempt. The interest of most tax-exempt private activity bonds issued after August 7, 1986, is a preference item for purposes of the alternative minimum tax (IRC sec. 57(a)(5)).

Municipal bonds can be categorized according to the resources available for their repayment:

- General-obligation municipal bonds are backed by the unrestricted faith and credit of governmental units that have unlimited authority to tax property to meet their obligations.

- If the revenues that may be used to service municipal bonds are restricted in some way by the issuer, the bonds are limited-obligation municipal bonds. Such bonds are frequently revenue bonds that are serviced from the revenues generated by specific property such as municipally owned utilities.

- Insured municipal bonds are issued by some municipalities. The bonds are insured to protect bondholders in the event of default. Because of the reduced risk, insured municipal bonds have lower interest rates than comparable uninsured bonds.

U.S. Government Obligations

U.S. government obligations are considered to be of such high quality that their yields are frequently used as default-free rates. Interest on U.S. government obligations is subject to federal income tax but is, in most cases, exempt from state and local income taxes.

U.S. Savings Bonds

U.S. savings bonds are nonmarketable obligations. Series EE bonds are currently being issued. They earn a variable interest rate equal to 85 percent of the market yield on five-year Treasury notes, with a floor of 6 percent. If the bonds are held for less than five years, the floor is reduced. Series HH bonds are similar but are obtained only by redeeming other savings bonds. Federal income tax on the accrued interest of savings bonds can be deferred until the bonds are redeemed for cash. (See page 3-7.06 for a discussion of when Series EE bonds can be used as qualified higher education savings bonds.)

Treasury Bills

U.S. Treasury bills are short-term notes sold at a discount from their face amount. They mature in thirteen, twenty-six, or fifty-two weeks. The minimum face amount sold is $10,000, and they are available in $5,000 increments above that amount. Because the interest is not taxable until received, Treasury bills that mature after a holder's tax year-end effectively defer taxation on the accrued interest.

Treasury Notes

Treasury notes pay a fixed amount of interest semiannually. They usually have maturities of from one to seven years and are readily marketable.

Treasury Bonds

Treasury bonds are marketable Treasury obligations that pay interest semiannually at a fixed rate. Their maturities are from seven to thirty years, and some issues are callable.

U.S. Agency Bonds

Certain U.S. government agencies, such as the Federal Home Loan Bank, the Federal Home Loan Mortgage Association, the Government National Mortgage Association (GNMA), and the Federal Home Administration (FHA) can issue their own debt obligations. Those obligations are generally not guaranteed by the U.S. government and,

consequently, pay slightly higher yields than Treasury obligations. It is considered unlikely, however, that the U.S. government would let any of its agencies default on its obligations.

Zero Coupon Bonds

Zero coupon bonds (zeros) pay no interest before maturity. They are sold at large discounts to generate a particular yield when redeemed at maturity for their face amount. Zeros eliminate the problem of reinvesting interest payments at possibly less variable yields. Interest income is deemed to accrue semiannually until maturity and is calculated by using the bond's effective yield. A disadvantage to holders is that the accrued interest is subject to federal income tax in the year it accrues. That is not a problem, however, if the bonds are held in a tax-deferred vehicle such as a qualified retirement plan. The accrued interest on zero coupon municipal bonds is, of course, tax- exempt.

Put Bonds

A put bond is a bond issued together with a put that permits the holder to sell the bond back to the issuer for a specified price before the expiration date of the put. The put in effect establishes a floor for the bond's price.

MORTGAGE-BACKED SECURITIES

The Veterans Administration, the FHA, and the GNMA guarantee home mortgages against default. Mortgage-backed securities are securities issued to finance purchases of pools of such guaranteed mortgages. For example, Ginnie Maes are actively traded securities whose underlying assets are mortgages guaranteed by GNMA. Although holders of Ginnie Maes are protected from default on the underlying mortgages, they are subject to interest rate risk, the risk that increased interest rates will cause the market price of the Ginnie Maes to decline.

REAL ESTATE MORTGAGE INVESTMENT CONDUITS

Real estate mortgage investment conduits (REMICs), entities created by the Tax Reform Act of 1986, are tax-advantaged vehicles for issuing multiple-class, mortgage-backed securities. The two classes of REMIC owners are taxed differently. Entities qualifying as REMICs are conduits like mutual funds for tax purposes.

REMICs own a pool of mortgages and issue a series of securities with varying maturities. If the REMIC sponsor is a federal agency that insures mortgages, such as the Federal Home Loan Mortgage Corp., the pooled mortgages will be insured.

Holders of regular REMIC interests will receive a specified principal amount and a predetermined interest rate, which may be variable. They are taxes on a debt instrument, including a tax on the accrued amount of original issue discount for each period. Sponsors of REMICs are subject to different tax rules.

CONVERTIBLE SECURITIES

Convertible securities are usually preferred stocks or bonds that are convertible into common stock. These securities provide fixed income as preferred stocks or bonds while allowing the investor to participate in future increases in the value of the firm's common stock, if any. The conversion feature is not free. Convertible securities generally sell at prices above those of comparable nonconvertible securities. When issued, the price of a convertible security is normally higher than the value of the converted security.

The conversion feature is sometimes not exercisable until two or three years after the issue date. It may expire after ten or fifteen years, although the conversion feature of preferred stock usually has an unlimited life. Convertible securities may be callable.

The call feature permits the issuer to force conversion if the value of the converted security is well above the face amount or par value of the bond or preferred stock.

INVESTMENT COMPANIES

To achieve adequate diversification, investment analysts often recommend a portfolio of about ten different stocks. In addition to about $1,000,000, an investor needs expertise and time to manage such a common stock portfolio. Instead of managing their own portfolios, many investors buy shares in regulated investment companies, companies specially set up to manage security portfolios.

Open-end investment companies have no fixed number of shares and continuously sell new shares and redeem old shares at the company's net asset value, which is equal to total assets less liabilities divided by the number of outstanding shares on a particular day. Such investment companies are usually called mutual funds. Close-end investment companies can sell only a specified number of shares, and after that, new shares are no longer issued. Shares of closed-end investment companies are traded like corporate stock on organized exchanges or over the counter. The prices of the shares are not necessarily equal to the companies' net asset value per share.

To avoid double taxation, registered investment companies meeting Internal Revenue Code requirements are not taxed on income they pass through to shareholders. An investment company's shareholders are subject to tax on their share of the investment company's distributable income.

Money Market Funds.

Money market funds are mutual funds that invest exclusively in debt instruments maturing within a year, such as U.S. Treasury bills and certificates of deposit. These funds provide more safety of principal than other funds because their net asset value never fluctuates. Each share has a net asset of $1. The yield, however, fluctuates daily.

Mutual Funds.

Mutual funds other than money market funds invest primarily in common stocks, bonds, or both. The funds publish prospectuses, which are available to investors. The prospectuses describe the funds' objectives; many of the types of mutual fund objectives are described below. Funds are often limited in the assets in which they can invest.

Forbes, Money Magazine, Business Week, and other periodicals publish semiannual or annual performance data on mutual funds. Information about no-load funds is contained in The Individual Investor's Guide to No Load Mutual Funds, published annually by the American Association of Individual Investors, 612 North Michigan Avenue, Chicago, IL 60611. Mutual funds vary in their investment objectives. The following are some of the more common objectives.

- Growth funds. These funds seek common stock with a high potential for appreciation. Income concerns are secondary.

- Maximum growth funds. Funds seeking maximum growth try to achieve capital appreciation by taking larger risks. Some may borrow money, sell stock short, and buy options.

- Balanced funds. Balanced funds seek maximum returns by buying both stocks and bonds. They often assume less risk than growth funds.

- Growth/income funds. Income funds try to maximize current income. They may hold fixed-income securities.

- International funds. International funds hold mostly non-U.S. securities. Some international funds limit their holdings to securities from a specific region, such as Australia, the Pacific Basin, or Europe.

- Small company funds. These funds invest in the securities of small companies.

- Specialty funds. Specialty funds limit their investments to a specific industry or geographic region.

- Bond funds. Funds investing primarily in corporate bonds seek higher rates of return than money market funds and Treasury obligations without being exposed to as much risk as stock funds. There are short-term, medium-term, and long-term corporate bond funds.

- Municipal bond funds. Funds investing in tax-exempt municipal bonds generate federally tax-exempt income. Some of these funds are insured. Some short-term muni funds are tax-exempt money market funds; their yield fluctuates, but the shares always have a $1 net asset value. Muni funds composed entirely of municipal bonds from one state or city have been developed for residents of some high-tax states such as New York and California. Residents are exempt from state taxes, or state and local taxes, as well as from federal tax on income from such funds.

Investment Company Characteristics

Characteristics to consider in selecting an investment company include --

- The fund's historical performance over a five or ten-year period.
- The fund's performance in bull markets and bear markets.
- The fund's sales charges, called loads, which vary from zero (no-load funds) to 8.5 percent. In addition, some funds charge redemption fees on withdrawals and some have deferred charges on withdrawals that usually end if the shares are held for five years.
- The fund's expense ratios, which are fund expenses expressed as a percentage of average net assets. The ratios measure the amount shareholders pay for professional management. The average expense ratio in 1986 was about 1.25 percent.

REAL ESTATE

Real estate investments usually include an ownership interest in land, residential property, commercial property, or industrial property. Depending on the investment, it may provide the investor (1) an opportunity to use leverage, (2) tax shelter benefits (subject to the at-risk rules and the passive loss rules of the Tax Reform Act of 1986), (3) long-term appreciation as a hedge against high inflation, and (4) cash flow. Direct investments in real estate, however, may involve high transaction costs, long-term financial commitments, management time or expense, long periods of negative cash flows, and lack of liquidity.

Real estate investments may take the form of direct investments or investments in general partnerships, joint ventures, limited partnerships, publicly traded master limited partnerships, or real estate investment trusts (REITs).

Qualified REITs are investment conduits not unlike mutual funds. Shareholders have an equity position in a portfolio of real estate and real estate obligations. REITs meeting Internal Revenue Code requirements may have no income tax at the trust level. Income is distributed, and taxed, to shareholders.

OIL AND GAS

Oil and gas ventures include varying amounts of risk. The riskiest of these ventures involve exploratory drilling in new areas. Developmental near successful wells is less risky. Income projects, producing oil and gas from successful wells, involve the least risk.

The tax shelter features of oil and gas projects (that is, deductible intangible drilling costs [IDCs] and depletion) remain after the Tax Reform Act of 1986, although, as previously, they may create tax preference items for purposes of the alternative minimum tax. In addition, working interests in oil and gas, regardless of whether the investor materially participates in the venture, are not subject to the passive loss rules of the act. Consequently, tax deferral resulting from high up-front deductions is still possible in oil and gas for those clients willing and able to accept the risks of working interests.

A working interest is an interest that bears responsibility for the cost of developing and operating the project and shares in tort liability. Limited liability interests, such as limited partnership interests and S corporation shares, are not considered working interests, nor are rights to overriding royalties, production payments, or contract rights to share in profits but not production costs.

Like other tax shelters, the following items should be considered in evaluating projects: commissions, broker-dealer fees, syndication fees, management fees, the sponsor's previous experience and success in the geographic area, the sponsor's financial commitment to the project, and additional amounts investors may be required to invest.

TAX SHELTERS AND PASSIVE INCOME GENERATORS

By using deductions, depreciation, tax credits, and leveraging, tax shelters have historic-ally offered investors the possibility of high up-front deductions, tax credits, and the conversion of ordinary income to capital gain income. The passive loss rules dealt such a serious blow to tax shelters that a new product has been developed, passive income generators (PIGs). Some clients may benefit from converting portfolio income (that is, interest and dividend income from securities) to PIGs--an investment that will generate passive income--to offset their tax shelter passive losses that would otherwise be deferred. The tax status of the assets to be converted and clients' overall tax and financial situations need to be considered before making a decision to convert assets to PIGs. PIGs are often real estate projects involving little or no leverage. Strategies using PIGs, however, require caution because limited partnerships meeting the Code's definition of publicly traded partnerships generate income that is classified as portfolio income for tax purposes and therefore cannot offset passive losses.

Other clients may seek tax shelters because they can use the passive losses. The prospectuses for both shelters and PIGs need careful analysis for a determination of the projects' risks, the fees and costs, the amount of the net investment, the existence of possibly

overvalued assets, the future payments that may be required, the economic prospects of the projects, the sponsor's previous experience and success, and so forth. The tax shelters may be equipment leasing, research and development, real estate, or other projects.

PRECIOUS METALS

Precious metals such as gold, silver or platinum are sometimes held as investments to diversify a portfolio or as a hedge against high inflation. Such investments are speculative because metal prices are volatile in periods of inflation, worldwide political uncertainty, and international currency fluctuations. The metals do not provide annual cash flows.

Precious metals can be bought from dealers as bullion or coins. Alternatively, investors can hold shares in mutual funds specializing in gold mine securities.

COLLECTIBLES

Investment-grade collectibles are sometimes held to diversify a portfolio and provide a hedge against inflation. To be investment-grade, the collectibles should be of superior quality, rare, readily marketable, and popular. Such collectibles include certain rare coins, stamps, gems, art, and antiques. Selecting collectibles requires expertise. An investor lacking such expertise may require the assistance of a reputable dealer or consultant.

Some collectibles have provided steady appreciation and a hedge against inflation. Be-cause of high transaction costs -- dealer fees, commissions, and mark-ups--collectibles usually have to show significant appreciation before a collector can realize a gain. They are therefore generally suitable only for long-term investments. Shifts in popularity can greatly affect their prices. They do not, of course, generate current income.

COMMODITIES

Investments in commodities are usually investments in futures contracts; they are agreements to make or accept delivery of a specified commodity (such as wheat, corn, or cocoa) on a certain future date. Low margin requirements for futures contracts permit investors to purchase them for 5 - 10 percent of their future value. Because contracts are usually on large quantities of the commodities, such as 5,000 bushels, small variations in the price of the commodity can mean large variations in the value of the contract. If the price move is unfavorable to the investor, it may eliminate the margin funds and re-quire the investor to immediately add funds to the account.

Commodities offer the possibility of enormous profits in a short time, but the risks are high. Seventy percent of commodity speculators lose money, and aggregate losses are typically five to six times greater than gains. [5]

Because commodity prices fluctuate daily, commodity investors must have, in addition to expertise, the time to monitor their investments daily. Instead of taking commodity positions directly, investors can obtain professional management by investing in commodity limited partnerships or mutual funds. Such managed accounts are also highly speculative, however.

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[5] Stephan R. Leimberg, Martin J. Satinsky, and Robert T. LeClair, The Tools and Techniques of Financial Planning (The National Underwriter, Cincinnati, Ohio 1988.)

INVESTMENT PLANNING

DATA-GATHERING FORMS

Exhibit 3-6K

Investment Alternatives Questionnaire

Name _____ Date _____

Liquid, income-producing, and growth investment products are listed below. Please indicate your preference for and familiarity with each. Also indicate whether you think the investment product would be suitable for your portfolio, considering your investment objectives.

	Preference					Familiarity					Suitability		
	High				Low	High				Low	Yes	No	Not Sure
Liquid Assets													
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
Income Producing													
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
Growth													
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___
_____	5	4	3	2	1	5	4	3	2	1	___	___	___

Investment Categories

This listing is meant to be helpful in preparing exhibit 3-6K for client use. It is not meant to be all-inclusive.

Liquid Assets

Money market funds
Savings account
NOW account
Certificates of deposit
U.S. Treasury bills
Tax-exempt money market funds

Income Producing

Bonds:

- Corporate
  - Convertible
  - Zero coupon
  - Put bonds
- Municipal
  - General obligation
  - Limited obligation
  - Insured
  - Zero coupon
- U.S. government obligations
  - U.S. savings bonds
  - Treasury notes
  - Treasury bonds
  - U.S. Agency bonds
- Mortgage-backed securities
  - Ginnie Maes
  - Fannie Maes

Stocks:

- High dividend common
- Preferred

Mutual funds:

- Income
- Corporate and government bonds
- Municipal bonds

Fixed annuities

Growth

Mutual Funds:

- Growth
- Maximum growth
- Balanced
- Growth/income
- International
- Small company
- Specialty

Real Estate:

- Direct ownership
- Investment Trust (REIT)
- Limited partnership
- Master limited partnership

Oil and Gas:

- Working interest
- Limited partnership
- Royalty interest

Collectibles:

- Antiques
- Art
- Coins
- Gems
- Stamps

Precious Metals:

- Gold bullion
- Gold certificates
- Gold mutual funds
- Silver
- Platinum

Insurance Products:

- Single premium whole life
- Universal life
- Variable life

Other:

- Variable annuities
- Futures
  - Commodity
  - Foreign currency
  - Interest rate
  - Stock index
- REMICs

Securities-Allocation Model

Part 1

Name_____ Date_____

Portfolio Scoring System

Score the importance to you of each investment objective according to the following table:

Goals	Most	Very	Some	Little	None	Score
High long-term total return	5	4	3	2	1	_____
Tax deferred appreciation	5	4	3	2	1	_____
High after-tax current income	1	2	3	4	5	_____
Low total return fluctuation	1	2	3	4	5	_____
Low single period loss probability	1	2	3	4	5	_____
High liquidity	1	2	3	4	5	_____
Total score						_____

(Use exhibit 3-60 to determine the suggested portfolio allocation for the client's total score.)

Adapted from William G. Droms, "Investment Asset Allocation for PFP Clients." Journal of Accountancy, April 1987, p. 116.

Securities-Allocation Model 2

Part 1

Name _____ Date _____

Portfolio Scoring System

Please circle the number that best describes the following areas:

	STRONGLY AGREE	AGREE	NEUTRAL	STRONGLY DISAGREE	DISAGREE	SCORE
o Earning a high long-term total return that will allow my capital to grow faster than the inflation rate is one of my most important investment objectives.	5	4	3	2	1	_____
o I would like an investment that provides me with an opportunity to defer taxation of capital gains and/or interest to future years.	5	4	3	2	1	_____
o I do not require a high level of current income from my investments.	5	4	3	2	1	_____
o My major investment goals are relatively long-term.	5	4	3	2	1	_____
o I am willing to tolerate sharp up and down swings in the return on my investments in order to seek a potentially higher return than would normally be expected from more stable investments.	5	4	3	2	1	_____
o I am willing to risk a short-term loss in return for a potentially higher long-run rate of return.	5	4	3	2	1	_____
o I am financially able to accept a low level of liquidity in my investment portfolio.	5	4	3	2	1	_____
Total Score						_____

(Use exhibit 3-6P to determine the suggested portfolio allocation for the client's total score.)

Adapted from William G. Droms, "Portfolio Allocation Scoring System, Version 3."

INVESTMENT PLANNING

WORKPAPERS

Securities-Allocation Model

Part 2

Objective: To determine the client's portfolio allocation based on the total score computed on exhibit 3-6M.

Name: _____ Date: _____

Suggested Portfolio Allocation

The client's portfolio mix should be similar to the allocation that matches the score on exhibit 3-6:

Score	Liquid (Money Market)	Income Producing (Fixed Income)	Growth (Equities)
30	5%	5%	90%
26-29	10%	10%	80%
21-25	20%	20%	60%
16-20	30%	30%	40%
11-15	40%	40%	20%
6-10	50%	40%	10%

Growth assets should be distributed according to the mix that matches the score:

Score	Income	Growth	Aggressive
30	10%	40%	50%
26-29	10%	60%	30%
21-25	50%	25%	25%
16-20	50%	30%	20%
6-15	50%	50%	0%

Adapted from William G. Droms, "Investment Asset Allocation for PFP Clients." Journal of Accountancy, April 1987, p. 116.

Securities-Allocation Model 2

Part 2

Objective: To determine the client's portfolio allocation based on the total score computed on exhibit 3-6N.

Name: _____ Date: _____

Suggested Portfolio Allocation

The client's portfolio mix should be similar to the allocation that matches the score on exhibit 3-6N:

Total Score	Liquid (Money Market)	Income Producing (Fixed Income)	Growth (Equities)
30-35	10	10	80
22-29	20	20	60
14-21	30	30	40
7-13	40	40	20

Adapted from William G. Droms, "Portfolio Allocation Scoring System, Version 3."

Exhibit 3-6Q

Current Value of Present Portfolio

Client _____ Date _____

Objective: To summarize, by investment objective, the client's liquid assets and investments listed in exhibit 3-2B; to determine if liquid assets and investments need repositioning.

	Percent	Total $	Investment Account $	Retirement Accounts (IRAs, etc.) Self-directed	Retirement Accounts (IRAs, etc.) Not Self-directed	Recommended Changes and Explanation
Liquid Investments						
Cash						
Checking accounts						
Savings accounts						
Certificates of deposit						
Money market accounts						
Cash value of life insurance						
Other _____						
Total Liquid Investments						
Income-Producing Investments						
Municipal bonds						
U.S. government notes and bonds						
Corporate bonds						
Rental property						
Notes receivable						
Other _____						
Total Income-Producing Investments						
Growth-Oriented Investments						
Common stocks						
Mutual funds						
Closely-held business						
Partnership interests						
Land						
Other _____						
Total Growth-Oriented Investments						
Total Investments						

Exhibit 3-6R

Cost-Comparison Worksheet -- Mutual Funds

Objective: Used together with exhibit 3-6S to compare the fees charged by various funds.

Client_____ Date_____

(1) Fund Name	(2) Projected Investment Term	(3) Front-End Load Amount (per share)	(4) Present Value of Back-End Load (per share)	(5) Present Value of Future Fees (per share)	(6) Total Present-Value Cost (per share)

Column 1 - Include the fund family and the fund name.

Column 2 - Estimate the number of years you expect the investment to be held.

Column 3 - Multiply the sales charge percent, if any, by the price of each share.

Column 4 - Compute the estimated future value per share of each fund using the projected annual total return percent, the number of years in column 2, and the current price per share. (See table 2 in the unit 3 appendix.) Multiply the result by the stated exit-fee percent. Compute the present value of the result using the same interest rate and term. (See table 1 in the unit 3 appendix.)

Column 5 - Compute the present value of an annuity equal to the expected annual management fee (plus 12b-1 expenses if separately stated). Use the amount in column 2 for the term. Use the same interest rate as for column 4. Use the amount of current fees per share as the amount of annual period payments. (See table 3 in the unit 3 appendix.)

Column 6 - Total of columns 3, 4, and 5.

Investment-Efficiency--Mutual Funds

Objective: Used together with exhibit 3-6R to compare the fees charged by various funds.

Client_____ Date_____

(1) Fund Name	(2) Price Per Share	(3) Total Cost (Exhibit 3-6R, Col. 6)	(4) Net Value Per Share (Col. 2 less Col. 3)	(5) Efficiency Factor Col. 4 ÷ Col. 2

Portfolio Manager-Evaluation Checklist for Mutual Funds

Objective: To assist in a comparison of different mutual funds by providing an analysis of a fund's management investment objectives and investment strategies.

Client_____ Date_____

Fund Name_____	Yes	No	Comments
1. The fund's top management team has substantial experience managing investment portfolios.	___	___	_____
2. Top management's experience has been with funds of similar size.	___	___	_____
3. Top management's experience has been with funds of similar investment objectives.	___	___	_____
4. Top management has substantial experience managing investment portfolios with equivalent investment strategies involving the industries and/or companies included in the current portfolio.	___	___	_____
5. Top management's previous achievements are similar to the fund's expected results.	___	___	_____
6. The fund's investment objectives are compatible with those of the client.	___	___	_____
7. The fund's investment strategies allow adequate flexibility to maneuver successfully within the marketplace (e.g., restrictions as to size of companies in the portfolio and the percentage of ownership of each company, are not excessively confining).	___	___	_____

Life Insurance Investment-Products Worksheet for Comparison of Life Insurance Companies

Objective: To obtain a comparative evaluation of life insurance investment products, including the financial strength of the insurance companies offering the products.

Client_____ Date_____

Criteria	Policies 1	2	3	Remarks
1. A.M. Best Rating.				
2. Top management is long term with company (L), long term with industry (E), or new to company (N).				
3. Reserves are superior (S), average (A), or below average (B).				
4. Investment strategy is conservative (C), balanced (B), aggressive (A), or self-directed by client (D).				Match this profile to your client's attitude toward risk.
5. Spread between company's return on assets and projected internal rate of return on policy (current year).				A larger spread indicates the ability to sustain the projected return on the policy.
6. Spread between company's average return on assets for the last five years and current year projected internal rate of return on policy.				
7. Percent of contracts that are reinsured.				A low percentage is an indication of financial strength.
8. Maximum retention level.				Maximum death benefit the company will write without reinsurance.
9. Cost per net payment cost method.				From exhibit 3-5F.
10. Cost per surrender cost method.				From exhibit 3-5F.
11. Insurance cost (total first 10 years).				Col. H in exhibit 3-6V.
12. Policy loan rate.				
13. Other.				

Life Insurance Investment-Products
Calculation of Mortality Costs
and Other Expenses

Objective: To calculate mortality costs and other expenses on a life insurance investment product for the purpose of comparing those costs and expenses with those of other insurance products.

Name _____ Date _____

Policy _____

Initial Face Amount: $500,000
Monthly Premium: $200.00
Assumed Rate of Return: 10.5%

A End of Year	B Age	C Annual Outlay	D Death Benefit	E Cumulative Outlay	F Accumulated Value	G Surrender Value	H Mortality and Other Costs
1	38	2,400	500,000	2,400	1,404	0	996
2	39	2,400	500,000	4,800	2,885	708	1,066
3	40	2,400	500,000	7,200	4,436	2,259	1,152
4	41	2,400	500,000	9,600	6,061	3,884	1,240
5	42	2,400	500,000	12,000	7,833	5,656	1,264
6	43	2,400	500,000	14,400	9,771	7,594	1,284
7	44	2,400	500,000	16,800	11,893	9,716	1,304
8	45	2,400	500,000	19,200	14,219	12,042	1,323
9	46	2,400	500,000	21,600	16,777	14,600	1,335
10	47	2,400	500,000	24,000	19,600	19,600	1,339
11	48	2,400	500,000	26,400	22,755	22,755	1,303
12	49	2,400	500,000	28,800	26,148	26,148	1,396
13	50	2,400	500,000	31,200	29,793	29,793	1,501
14	51	2,400	500,000	33,600	33,703	33,703	1,613
15	52	2,400	500,000	36,000	37,889	37,889	1,753
16	53	2,400	500,000	38,400	42,365	42,365	1,902
17	54	2,400	500,000	40,800	47,146	47,146	2,067
18	55	2,400	500,000	43,200	52,253	52,253	2,243
19	56	2,400	500,000	45,600	57,687	57,687	2,453
20	57	2,400	500,000	48,000	63,477	63,477	2,667
21	58	2,400	500,000	50,400	69,642	69,642	2,900
22	59	2,400	500,000	52,800	76,199	76,199	3,155
23	60	2,400	500,000	55,200	83,167	83,167	3,433
24	61	2,400	500,000	57,600	90,568	90,568	3,732
25	62	2,400	500,000	60,000	98,411	98,411	4,067

Information about the cost of insurance--mortality charges and administrative expenses--is needed to compare insurance contracts. It is generally not provided by the insurance company; however, the calculation below enables you to determine a policy's projected insurance costs from information provided by the insurer. It was used to determine the mortality and administrative costs shown in column H of the policy illustrated above.

The calculation requires information from the insurer about the annual premium, column C, and the accumulated value, column F. Because the calculation uses accumulated values, it is most useful if the client intends to hold the policy for more than ten years. It is important to note that the information in column F is the insurance company's projection based on an assumed credited rate of return that is not guaranteed.

Computation of mortality charges and administrative expenses:

n = current year
n-1 = prior year

1. Determine the increase in accumulated value since the prior year:
   Col. F in year n less col. F in year n-1.
   [For year 2: 2,885 - 1,404 = 1,481]

2. Determine the increase in accumulated value resulting from credited earnings on the accumulated earnings at the beginning of the year:
   Col. F in year n-1 times the rate of return assumed by the insurer.
   [For year 2: 1,404 X 0.105 = 147]

3. Determine the amount of increase in accumulated value resulting from the current year's premium payment:
   Subtract the answer from step 2 from the answer in step 1.
   [For year 2: 1,481 - 147 = 1,334]

4. Determine the mortality charges and administrative expenses in the current year:
   Subtract the answer in step 3 from col. C in year n.
   [For year 2: 2,400 - 1,334 = 1,066]

CHECKLIST OF FACTORS TO CONSIDER IN SELECTING AN INVESTMENT MANAGER

NAME _____ DATE _____

COMMENTS

1. Past Performance
   - Greater weighting for complete stock market cycles _____
   - Lower weighting for less recent periods (less than 12 months) _____
   - Allowance for extraneous influences (especially luck) _____
   - Range of results by money manager _____

2. Charges
   - Money managers _____
   - Direct scale management charges _____
   - Discounted or retail commission transactions _____
   - Performance-based charges _____

3. Mutual funds
   - Sales commissions _____
   - 12b-1 fees _____
   - Back-end loads _____

4. Status of organization
   - Overall reputation and prestige _____
   - Length of history and size of total assets under management _____
   - Growth of assets managed _____

5. Investment Team
   - Seniority and experience _____
   - Individual attention (consider workload) _____
   - Technical caliber _____
   - Support from house policy _____
   - Quality of analysts _____
   - Use of information _____

6. Risk Profile Adopted by the Money Manager
   - Adventurous or timid style _____
   - Following the herd _____
   - Procedures to control risk _____
   - Investment in volatile assets _____
   - Overseas currency exposure _____

Comments

7. Strategy Adopted by the Money Manager
   - Past and present asset distributions _____
   - Asset philosophy _____
   - Attitudes regarding timing _____
   - Attitudes regarding security selection _____
   - Attitudes regarding sector selection _____

8. Flexibility of Management Style
   - Alteration of strategy in future _____
   - Responsiveness to changing client objectives and risk tolerance _____
   - Facility to change money manager and incident costs _____

9. Investment Administration
   - Easy registration _____
   - Past service history _____
   - Quality of written material _____

10. Portfolio Characteristics of the Money Manager
   - Reaction of economic and market conditions _____
   - Insight into structure, strategy, style and risk _____
   - Fundamental valuation against in benchmark _____
   - Trading flexibility _____

GOALS FUNDING WORKSHEET

OBJECTIVE: To determine the lump-sum or annual contribution required to fund a financial goal.

CLIENT _____ DATE _____

1. Goal _____
2. Current savings available _____
3. Estimated cost of accomplishing goal in today's dollars _____
4. Number of years until funding required _____
5. Estimated inflation rate for cost of goal _____
6. Estimated after-tax return on investments _____

Lump-Sum Computation

Step 1: Future cost of goal:
Line (3) x future value factor for line (4) years
at line (5) inflation rate (table 2 in appendix) = (A)

Step 2: Lump-sum required:
(A) x present value factor for line (4) years
at line (6) rate of return (table 1 in appendix) = (B)

Step 3: Additional funding required:
(B) minus line (2) = (C)

Annual Contribution Computation:

Step 1: Same as for lump-sum computation

Step 2: Future value of current savings:
Line (2) x future value factor for line (4) years
at line (6) rate of return (table 1 in appendix) = (D)

Step 3: (A) - (D) = (E)

Step 4: Required amount of annual contribution:
(E) minus future value of an annuity factor for
line (4) years at the interest rate on line (6)
(table 4 in appendix) = (F)

SUMMARY OF REQUIRED FUNDING

OBJECTIVE: To obtain an overview of the overall funding required to accomplish goals, to evaluate whether adequate resources are available, and whether the client's portfolio will be adequately diversified.

CLIENT _____ DATE _____

Goals In Order of Priority	Funding Plan		Rate of Return (%)	Suitable Investment Classes
	Lump Sum	Annual Contribution		
1._____	_____	_____	_____	_____
2._____	_____	_____	_____	_____
3._____	_____	_____	_____	_____
4._____	_____	_____	_____	_____
5._____	_____	_____	_____	_____
6._____	_____	_____	_____	_____
7._____	_____	_____	_____	_____
8._____	_____	_____	_____	_____
9._____	_____	_____	_____	_____

Total available investments _____

Available cash flow _____

Excess (deficiency) _____

INVESTMENT PLANNING

ILLUSTRATIVE WORKPAPERS WITH CLIENT RECOMMENDATION

Investment Preferences

Name Sample Client Date 3/21/X1

Described below are three primary benefits that are provided to some degree by all investments. No single investment maximizes all three; receiving more of one benefit usually means receiving less of another.

Safety of principal: The likelihood that the principal will be returned intact, without increase or decrease.
Cash flow: The amount of cash flow that the investment will generate annually.
Appreciation: The amount of gain that will be realized upon sale of the asset.

Indicate below the benefits you would desire from your investments by circling the appropriate numbers. The total of the numbers circled for "All Holdings" should equal ten and the total of the numbers circled for your "Next Investment Only" should equal ten.

	All Holdings						Next Investment Only					
	High					Low	High					Low
Safety of principal	5	4	3	2	1	0	5	4	3	2	1	0
Cash flow	5	4	3	2	1	0	5	4	3	2	1	0
Appreciation	5	4	3	2	1	0	5	4	3	2	1	0
	Total = 10						Total = 10					

Listed below are four characteristics of investments. Unlike the benefits above, you can have as much or as little of each characteristic without affecting the others. Trade-offs are involved, however, because each characteristic has both favorable and unfavorable aspects.

Liquidity: The ease of converting the investment to cash within a short time.
Debt: The extent to which you are personally obligated for debt associated with the investment.
Risk and return: The degree of uncertainty about the results of the investment and the magnitude of the total return. In most cases, increased risk should mean increased return.
Management effort: The degree to which you are personally involved with the operation and decision-making aspects of the investment.

Indicate below your preference for those characteristics:

	All Holdings					Next Investment Only				
	High				Low	High				Low
Liquidity	5	4	3	2	1	5	4	3	2	1
Debt	5	4	3	2	1	5	4	3	2	1
Risk/return	5	4	3	2	1	5	4	3	2	1
Management effort	5	4	3	2	1	5	4	3	2	1

Securities-Allocation Model

Name Sample Client Date 3/21/X1

Portfolio Scoring System

Score the importance to you of each investment objective according to the following table:

Goals	Most	Very	Some	Little	None	Score
High long-term total return	5	4	3	2	1	3
Tax-deferred appreciation	5	4	3	2	1	3
High after-tax current income	1	2	3	4	5	3
Low total-return fluctuation	1	2	3	4	5	1
Low single-period loss probability	1	2	3	4	5	1
High liquidity	1	2	3	4	5	3
Total Score						14

Suggested Portfolio Allocation

Your portfolio mix should be similar to the allocation that matches your score:

Your Score	Money Market	Fixed Income	Equities
30	5%	5%	90%
26-29	10%	10%	80%
21-25	20%	20%	60%
16-20	30%	30%	40%
11-15	40%	40%	20%
6-10	50%	40%	10%

Your equities should be distributed according to the mix that matches your score:

Your Score	Income	Growth	Aggressive
30	10%	40%	50%
26-29	10%	60%	30%
21-25	50%	25%	25%
16-20	50%	30%	20%
6-15	50%	50%	0%

Adapted from William G. Droms, "Investment Asset Allocation for PFP Clients." Journal of Accountancy, April 1987, p. 116.

Projected Financial Condition Workpaper for the Years 19X1 through 19__

Objective: To evaluate whether the personal financial plan will enable the client to reach financial goals.

Name Sample Client Date 3/24/X1

Assets	19X1	19__	19__	19__	19__
Liquid Assets					
Cash and checking accounts	$ 3,000	$	$	$	$
Savings accounts	3,550				
Money market funds	106,851				
Certificates of deposit					
Brokerage accounts					
Life insurance cash value					
Other liquid assets					
Total Liquid Assets	113,401				
Marketable Securities					
Listed stocks/funds					
Federal notes and bonds					
Corporate bonds/funds					
Municipal bonds/funds					
Other marketable securities					
Total Marketable Securities					
Other Investments					
Business interests					
Partnership interests					
Investment in real estate					
Investment-grade collectibles					
Retirement accounts:					
Pension accounts					
Profit-sharing accounts					
Deferred compensation/401(k) plans					
IRA accounts					
Keogh accounts					
Other--installment note	264,936				
Total Other Investments	264,936				
Personal Assets					
Residence	400,000				
Vacation home					
Automobiles/boats					
Furniture and household accessories					
Other personal property	40,000				
Total Personal Assets	440,000				
Total Assets	$818,337	$	$	$	$

Projected Financial Condition Workpaper
for the Years 19X1 through 19__

Liabilities and Net Worth	19X1	19__	19__	19__	19__
Current Liabilities					
Charge accounts, credit card charges, and other bills payable					
Installment credit and other short-term loans					
Current portion of long-term debt	2,400				
Unusual tax liabilities					
Total Current Liabilities	2,400				
Long-Term Liabilities					
Mortgage notes on personal real estate	33,600				
Mortgage notes on investment real estate					
Bank loans					
Margin loans					
Life insurance policy loans					
Other					
Total Long-Term Liabilities	33,600				
Total Liabilities	36,000				
Family Net Worth	782,337				
Total Liabilities and Net Worth	818,337				

Short Data-Gathering Form
Cash Flow Plan
[Monthly ( ) or Annual (X)]

Name Sample Client Date 3/24/X1

Income and Fixed Expenses		
Income from employment	$ 50,000	
Other income	7,017	
Total		$ 57,017
Fixed expenses:		
Housing	17,555	
Food	3,120	
Clothing	1,000	
Transportation	450	
Education		
Taxes	15,500	
Other	885	
Total		38,510
Excess		18,507
Discretionary Expenses:		
Entertainment	3,000	
Gifts	700	
Contributions	900	
Other	880	
Total		5,480
Available for Savings or Investment		$ 13,027

5/90

Illustrative Communication to the Client

Mr. Sample Client
Middletown, U.S.A.

Dear Mr. Client:

We are pleased to have the opportunity to assist you in developing your investment plan. Before we begin to discuss the data and recommendations, we would like to focus your attention on aspects associated with this information.

Prospective Financial Information

We have assembled from data provided by you the accompanying forecasted cash flow information. This forecasted information was prepared solely to help you and your financial advisers develop your personal investment plan. Accordingly, it does not include all disclosures required by the guidelines established by the American Institute of Certified Public Accountants for the presentation of a financial forecast. We have not compiled or examined the forecasted cash flow information and express no assurance of any kind on it. The forecasted financial information should not be used for any purpose other than developing your personal investment plan. It may differ materially from actual results because events and circumstances frequently do not occur as expected.

For the Firm

August 25, 19XX

Sample Client
Investment Planning Recommendations
August 25, 19XX

The following is an analysis of aspects of Sample Client's investment plan. At the initiation of this engagement, you indicated that you needed help in investing your excess cash flow. To address that concern, you requested that we assist you by recommending investment alternatives suitable to your situation.

The forecasted cash flow information included in this analysis was prepared to help you and your advisers develop your personal investment plan and should not be used for any other purpose. It may differ materially from actual results because events and circumstances frequently do not occur as expected. The forecasted information is based on the following significant assumptions that you concluded are the most likely assumptions based on currently available information:

1. Your salary will be $50,000. It increases at about double the rate of inflation.

2. Your investment income will be about $7,000.

3. You will have fixed and discretionary expenses of $44,000. They remain fairly constant, after adjusting for inflation.

Recommendations

Based on your forecasted cash flow for 19X1, it appears you will have excess cash receipts over expenditures totaling $13,000. A reduction of the excess cash receipts would not impair your financial situation. Your combined federal and state marginal income tax rate is 37 percent. Most of the excess cash flow will be taxed at your highest marginal bracket. (A marginal tax rate is the percentage applied to the income in the highest bracket.) Removing taxable income from your highest bracket will reduce federal and state income taxes. Investing in products whose income is exempt or deferred from taxation by law can reduce federal and state income taxes; however, many such investments are subject to risks that may not be appropriate to your circumstances at this time. Furthermore, tax-advantaged investments are sometimes illiquid, and require fees and other costs as part of the purchase price. These fees and costs are usually subtracted from the amount placed into the investment. At the present time, we would recommend two investment products that would enable you to defer federal and state income taxes on the income they generate for an indefinite period. The safety of these two investments is excellent and both are very liquid.

Series EE United States savings bonds are issued by the United States Treasury in denominations from $50 to $10,000. These bonds cost one-half of their face value. A Series EE bond with a $10,000 face value would cost $5,000. The

bonds are registered in the names of individuals and provide for single ownership, co-ownership, or may be purchased in beneficiary form. Purchases of Series EE bonds are limited to $30,000 face value ($15,000 issue price) a year for each individual; however, if the bond is registered in co-ownership, the limit is increased to $60,000 face value ($30,000 issue price). Series HH bonds may be purchased by exchanging Series EE bonds, which can, in effect, perpetually defer any income tax on the appreciation of a maturing EE Bond. Interest on Series EE bonds accrues through periodic increases in the redemption value and is paid at the time the bond is cashed. All bonds held for five years will receive interest at 85 percent of the average return on marketable Treasury securities with five years remaining to their maturity, or 6 percent, whichever is higher. Interest is compounded semiannually. A Series EE bond may be redeemed six months after purchase. If it is cashed before being held five years, the Series EE bond will earn between 4.27 and 6.0 percent, depending on how long the bond has been held. Series EE bonds mature in twelve years. Series HH bonds pay the same variable interest rate. They can only be purchased from the proceeds of maturing U.S. savings bonds.

At your present federal and state combined marginal tax rate of 37 percent, the deferred Series EE bonds have an effective yield of 9.5 percent on a pretax basis.

The opportunity of purchasing the Series EE bonds in a co-ownership form has several advantages. It would allow you to make a gift of up to $15,000 without having to lose control of your funds. The bonds would be registered and either owner would have the right to cash in the bonds; however, only the person with custody of the bonds may redeem them. Since the Series EE bonds are tax deferred, neither owner would have to report the income on federal or state income tax returns.

For example, you could purchase $60,000 face value ($30,000 cost basis) of Series EE bonds with $15,000 in the names of you and your son and $15,000 in the names of you and your daughter. You could retain custody of the bonds. The savings in federal and state income taxes would be over $1,000 a year for as long as you own the bonds. In summary, the advantages of the strategy would be to reduce your federal and state income taxes for each year the bonds are held, to make a gift to each of your children without losing control of your funds, to receive a yield that is substantially higher than most other investments you could make without assuming substantial risk, and to have liquidity that would enable you to convert the bonds to cash without the risk of loss. We recommend that you either purchase $30,000 face value of Series EE U.S. Treasury bonds or purchase as co-owners with your two children, $60,000 face value of Series EE U.S. Treasury bonds. This strategy also may be appropriate for future years and should be considered annually to the limits of federal regulations.

Another investment that offers a similar opportunity for tax deferred income, as well as the preservation of principal and a high degree of liquidity and safety, is a single premium whole life insurance policy. It is an investment

product created by insurance companies within the last few years, and offers a tax deferred return on your money of up to 9 percent. It is available to individuals up to the age of 78 and does not require evidence of insurability or other features usually associated with a life insurance contract. It is fairly complicated and we would be happy to discuss it with you further. The tax savings on a $100,000 policy would be approximately $3,000 annually and a comparable taxable yield would be 14.29 percent under current federal laws. In summary, you would have an investment that would substantially reduce income taxes, produce a high rate of return, provide liquidity without the risk of loss, and have a very high degree of safety. Loans and other amounts received under the contract will be included in gross income to the extent that the policy's cash value exceeds the insured's investment in the contract.

At the present time, the investment markets are doing extremely well. If you desire to take a reasonable risk in growth stocks, we would recommend no-load mutual funds. Mutual funds offer an opportunity for an investor to reduce certain elements of risk through diversification. These funds are professionally managed and many have good track records and high ratings on performance. Although they are marketable and can be converted to cash in a short time, they are subject to market risk. If you have a desire to invest in mutual funds, we would suggest the total investment not exceed $50,000.

Changes in your personal circumstances, the economic environment, tax laws, and other circumstances could modify the appropriateness of the recommendations. Consequently, we suggest that you schedule periodic reviews of your financial situation to evaluate whether your investment strategy is suitable.